

HONG KONG MONETARY AUTHORITY ANNUAL REPORT 2006



HONG KONG MONETARY AUTHORITY
香港金融管理局

THE HONG KONG MONETARY AUTHORITY

Established in April 1993, 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, through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary
- to promote the safety and stability of the banking system through the regulation of banking business and the business of taking deposits, and the supervision of authorized institutions
- to enhance the efficiency, integrity and development of the financial system, particularly payment and settlement arrangements.



The theme of this Annual Report is the five elements of Chinese philosophy – water, wood, fire, earth and gold. The five elements, presented symbolically, suggest tradition, balance, harmony and the operation of an ordered system.

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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 2006 submitted by the Monetary Authority to the Financial Secretary in accordance with Section 9 of the Banking Ordinance.

This Annual Report makes reference to documents and other materials available on the HKMA website www.hkma.gov.hk. These references appear as , followed by navigation guidance from the HKMA homepage.

The full text of this Report is available on the HKMA website in interactive form and on PDF files.

A summary version of this Report is also available in *An Introduction to the Hong Kong Monetary Authority 2007 Edition*.

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

Highlights of 2006

Economic and Banking Environment

Hong Kong's economy registers above-trend growth for the third consecutive year. Real GDP grows by 6.8% in 2006.

The banking sector continues to achieve solid results in an intensely competitive operating environment with abundant liquidity.

Monetary Stability

The Hong Kong dollar remains stable and the money market remains calm, despite the appreciation of the renminbi.

The RTGS systems efficiently handle all fund flows, including many large equity initial public offerings, and register record transaction volumes.

Banking Stability

The drafting of and statutory consultation for the Banking (Capital) Rules and Banking (Disclosure) Rules are completed for the implementation of Basel II in January 2007.

The HKMA continues to strengthen the banking sector's ability to manage risks and prevent money laundering and terrorist financing.

The Deposit Protection Scheme is launched.

Market Infrastructure

The Renminbi Settlement System is launched to pave the way for a fully fledged renminbi RTGS system.

A payment-versus-payment link is established between Hong Kong's US dollar and Malaysia's ringgit RTGS systems.

International Financial Centre

The "1-3-5 financial development blueprint" is developed to foster financial co-operation between the Mainland and Hong Kong and build a bigger financial market.

The HKMA works with Mainland authorities to obtain approval for financial institutions on the Mainland to issue renminbi bonds in Hong Kong. Approval is given in January 2007.

Reserves Management

The Exchange Fund achieves an investment income of \$103.8 billion in 2006, or a return of 9.5%, which exceeds the benchmark investment return by more than 0.6%.

Total assets of the Exchange Fund reach \$1,176.7 billion at the end of 2006.

Chief Executive's Statement



The HKMA had another busy and, I believe, successful and productive year in 2006: the Hong Kong dollar exchange rate remained stable despite record fund flows, the banking sector remained strong, the Exchange Fund earned a respectable investment return, and some real progress was made in mapping out a strategy for Hong Kong's world-class financial infrastructure to contribute to the further development of China's economy.

Economic trends

Hong Kong's economy grew by 6.8% in 2006, lower than the 7.5% in 2005 but still above trend and very respectable. Monetary conditions eased, reflecting high levels of liquidity in the banking sector, but were broadly neutral. Unemployment declined to its lowest level in six years, while inflation picked up slightly but not yet to levels that would cause concern. Growth in the economy was mainly driven by domestic demand, particularly consumer spending and investment in business equipment. At the same time, exports of goods and services were robust with increases in trade with the Mainland and solid demand from our other major trading partners.

Asset markets performed well: the residential property market was stable after a strong rise in 2005, with little sign of overheating; and the stock market staged a strong rally in the second half of the year, with the Hang Seng Index increasing by 34% to reach a record high of 20,001 on 28 December. This rise was supported by Hong Kong's strong economic performance, the pause in monetary tightening in the US, and large inflows of funds related to initial public offerings, mostly of Mainland stocks.

The Exchange Fund

That the Exchange Fund enjoyed a good year in 2006 is already old news: the Fund earned an investment return of \$103.8 billion, a rate of return of 9.5%. This exceeded the rate of return of the benchmark portfolio approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee (EFAC) by more than 0.6%. The share of the investment income going to the fiscal reserves placed with the Exchange Fund was \$28.9 billion.

Good results are always welcome, of course. We are glad to have contributed to a healthy investment return for the people of Hong Kong. But we are also very conscious that this is not the primary purpose of the Exchange Fund. The purposes and investment objectives of the Fund are set out in detail in the Reserves Management chapter: in essence, the Fund is there to back the Hong Kong dollar, and to do that it has to be held primarily in liquid US dollar assets and its investment objectives emphasise capital preservation and liquidity. I have said this many times but perhaps it bears repeating once more: the Exchange Fund has to be invested, but it is not an investment fund and investment is not its primary purpose.

The implication of this is that we cannot and should not expect high returns from the Fund every year. Like the savings that many of us hold, the Exchange Fund can be thought of as rainy-day money: we want to get a good return on it but we must always remember that we might need it for some emergency and therefore be prudent in how we invest it. Looking ahead to 2007, I believe that caution is called for. While I believe we did well in outperforming the benchmark, the overall results of 2006 were due in large part to equities and bond markets rising together towards the end of the year and a number of equities markets in particular reaching historic highs. We all understand that markets are cyclical and when you reach high levels, the outlook for the future is uncertain at best.

Hong Kong dollar stability

The Hong Kong dollar exchange rate is always a focus for the HKMA given our mandate to preserve currency stability. I am pleased to say that the Hong Kong dollar remained stable within the Convertibility Zone throughout the year, despite some very large fund flows related to initial public offerings and speculation about the effect on the Hong Kong dollar of the renminbi's appreciation. Looking back at the 2005 Annual Report, I note that last year I talked about record fund flows from initial public offerings: those records were greatly exceeded in 2006 with \$333 billion being raised in the local stock market, including \$125 billion for a single issue.

Earlier in the year, many in the financial markets seemed to believe that the Hong Kong dollar would follow the renminbi in appreciating against the US dollar and other major currencies, and there was speculation that we would abandon the Linked Exchange Rate system. Quite why anyone should think that we would give up an anchor that has served us well and helped to maintain stability through some very difficult and potentially destabilising times over the last 23 years is something of a mystery. But the HKMA's job is to ensure stability and if people found my repeated statements that there was no plan or intention to abandon the link to the US dollar a little boring, then I do not mind very much. Dullness can be a virtue in our business. We spent a lot of time explaining to the markets and the wider community that the strengthening of the renminbi to parity with the Hong Kong dollar and beyond would not affect the Hong Kong dollar exchange rate, although we of course could not rule out short-term psychological effects on the financial markets. We also explained that, given the correlation of the business cycles in Hong Kong and the US and the fact that an overwhelming amount of our external trade is denominated in US dollars, the link with the US dollar remained appropriate for the Hong Kong economy and the best way to ensure stability. In the event, the markets largely shared this view and the renminbi passed through various psychologically significant levels without causing any ripples to the stability of the Hong Kong dollar: the Currency Board system functioned normally and we were not required to take any action to stabilise the exchange rate.

The banking sector

Hong Kong continues to have a robust banking system despite a very competitive operating environment. The profitability of the banks improved because of higher net interest margins and loan growth, leading to higher net interest income. Income from fees and commissions also increased, more than offsetting lower treasury income and an increase in provisions. Overall asset quality remained good: although the credit card portfolio weakened slightly, the decline in quality was from a level many other markets would regard with envy and the resulting increase in provisions was small by historical standards. The local banking sector is well placed to continue to support economic growth.

But that does not mean the HKMA should not remain active and vigilant in its role of promoting the safety and stability of the banking sector. In addition to the continuing day-to-day regulation work, largely unseen by the public but of great importance to ensuring a stable banking industry, the HKMA has been working hard to make improvements in this area. In 2006 my colleagues in the banking departments continued to develop risk-based supervision and completed the enormous volume of work related to the implementation of the Basel II arrangements, which formally began on 1 January this year when the *Banking (Capital) Rules* and the *Banking (Disclosure) Rules* came into force. Hong Kong is among the first jurisdictions in the world to implement Basel II and this makes us very much a leader in the region. A great deal more detailed and painstaking work lies ahead of us.

Hong Kong as an international financial centre

The Deposit Protection Scheme commenced operations on 25 September and the evidence so far suggests that the Scheme, which provides a measure of protection to depositors, is already helping to increase confidence in the banking sector. Another area where we increased our efforts in 2006 is in monitoring controls on money laundering and terrorist financing: sad to say, these problems are going to be with us for the foreseeable future and we have had to devote more resources to them. It would be a brave person who would say that we can prevent such dealings, but we are committed to doing everything we can to make it harder for criminals to abuse our financial systems.

The year saw a number of highlights in the development of Hong Kong as an international financial centre. The international credit rating agencies upgraded Hong Kong's sovereign ratings to AA, the highest they have ever been. The HKMA, working with the Government, played an important role in helping the agencies achieve a better understanding of Hong Kong's economic and financial strengths. We also worked hard during the year with the Mainland authorities on the expansion of renminbi business in Hong Kong, leading in January this year to the State Council's agreement to the issuance of renminbi bonds in Hong Kong by Mainland institutions, the first time that such instruments will be issued outside the Mainland.

The HKMA also developed a blueprint for the financial development of Hong Kong that was adopted as part of the report by the Focus Group on Financial Services set up by the Chief Executive's Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong". The blueprint aims to set out how Hong Kong's already developed financial systems can contribute to the development of the nation's economy and give China the kind of international financial centre the world's fourth-largest and fastest-growing economy ought to have. This is a long-term goal and I have no doubt the strategy will need to be revised from time to time and progress will sometimes seem slower than we would like. But it is surely something worth achieving and we should all commit ourselves to it.

A safe and efficient financial infrastructure

An aspect of Hong Kong's financial system that receives very little public attention is its world-class financial infrastructure. Efficient and safe payment and settlement systems are often taken for granted and few people not directly involved know much about them: people just assume that when they commit funds to a transaction, the money will arrive safely and on time at the other end. This is not the place for a detailed explanation of what are very complex systems but I will just note that on a single day, 27 October 2006, \$1.37 trillion, roughly equivalent to Hong Kong's annual gross domestic product, passed through the clearing-house system without any problems. There were also no settlement failures during the year. This does not just happen: a lot of people work very hard to ensure that the systems operate efficiently and the HKMA puts a great deal of effort not just into maintaining the systems but also into making sure that they are developed and improved to keep ahead of the demands placed upon them.

Governance and transparency

I am always conscious that the HKMA bears a great responsibility in the stewardship of public resources. We manage a very large amount of public money and perform functions that directly affect Hong Kong's financial well-being. The HKMA maintains a degree of separation from the rest of the Hong Kong Special Administrative Region Government, although we are an integral part of it. We have a certain level of autonomy in our day-to-day operations, in our funding arrangements, and in the employment of staff on terms different from those of the civil service. These arrangements are consistent with the generally accepted principle that central banking institutions should have resource independence to allow them to carry out their functions without political interference. But this does not mean that the HKMA should not be accountable for how it performs those functions and we are in fact accountable to the Financial Secretary through EFAC and to the community, both directly and through the Legislative Council. EFAC and its Sub-Committees, especially the Governance Sub-Committee, continue to keep a close eye on our operations and to offer us much valuable advice and guidance. We have adopted a policy of transparency that compares favourably with those of the major central banks around the world. I brief the Legislative Council's Panel on Financial Affairs three times a year on the work of the HKMA and matters affecting the economy. This Annual Report is also an important part of our transparency policy and this year we have included a number of improvements and additional items of information that I hope will help the community better understand what we do and how we do it.

Finally, I would like to thank my colleagues for their continued hard work and dedication during the year, and we are all grateful to the Members of EFAC who give up so much of their time and energy to provide us with their guidance.

A handwritten signature in black ink, consisting of a stylized 'J' followed by a long horizontal stroke that ends in a small hook.

Joseph Yam
Chief Executive

About the HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.

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

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.

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. The HKMA's weekly *Viewpoint* column, carried on the HKMA website and in several Hong Kong newspapers, informs the public about aspects of the HKMA's work. Further information on the HKMA's media work, publications and public education programmes is contained in the Chapter on Professional and Corporate Services.

 > Viewpoint

 > HKMA Information Centre

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 monthly reports on Currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996.

 > [Press Releases > Exchange Fund](#)

 > [Supervisory Policy Manual](#)

 > [Guidelines and Circulars](#)

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. At one of these briefings, usually in May, the HKMA's Annual Report is presented. 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.

 > [Legislative Council Issues](#)

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 includes 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.

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 2006 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 seven times in 2006 to consider a range of subjects including disclosure of information on the HKMA's expenditure budget, the HKMA's performance assessment, the annual pay review, the *HKMA Annual Report*, business continuity planning, strategic planning matters and post-termination employment arrangements. 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. The Sub-Committee met twice in 2006.

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 monthly reports on Currency Board operations submitted to the Sub-Committee are published. In 2006 the Sub-Committee met four times. Topics discussed included a review of the Hong Kong dollar effective exchange rate, estimating the demand for narrow money and broad money, Hong Kong's business cycle synchronisation with Mainland China and the US, and the implications of relaxing the three-year tenor issuance restriction on multilateral development banks for monetary stability and market development potential.

 [Press Releases](#) • [Monetary Policy](#)

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 2006.

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 2006 the Sub-Committee met three times.

The 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.

The 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.

Brief biographies of 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.

 > [The HKMA > Advisory Committees](#)

 > [The HKMA > The Chief Executive's Committee](#)

Advisory Committees



Patrick Fung

Peter Sullivan

Simon Ip

K C Chan

Patrick Wang

Christopher Cheng

Marvin Cheung

Joseph Yam

THE EXCHANGE FUND ADVISORY COMMITTEE

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP

The Financial Secretary

Members

Mr Joseph YAM, GBS, JP

The Monetary Authority

Dr The Hon. Marvin CHEUNG Kin-tung, DBA Hon., SBS, JP

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

The Hon. Victor LO Chung-wing, GBS, JP

Chairman and Chief Executive

Gold Peak Industries (Holdings) Limited

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer

Johnson Electric Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology



Henry Tang

David Li

Richard Wong

Victor Lo

He Guangbei

Henry Fan

Thomas Kwok

Vincent Cheng

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director
CITIC Pacific Limited

Mr Simon IP Sik-on, JP**Mr Thomas KWOK Ping-kwong, JP**

Vice-Chairman and Managing Director
Sun Hung Kai Properties Limited

Mr Peter SULLIVAN

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

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation Limited

Dr Patrick FUNG Yuk-bun

Chairman and Chief Executive
Wing Hang Bank Limited
(from 3 October 2006)

Professor Richard Y C WONG, SBS, JP

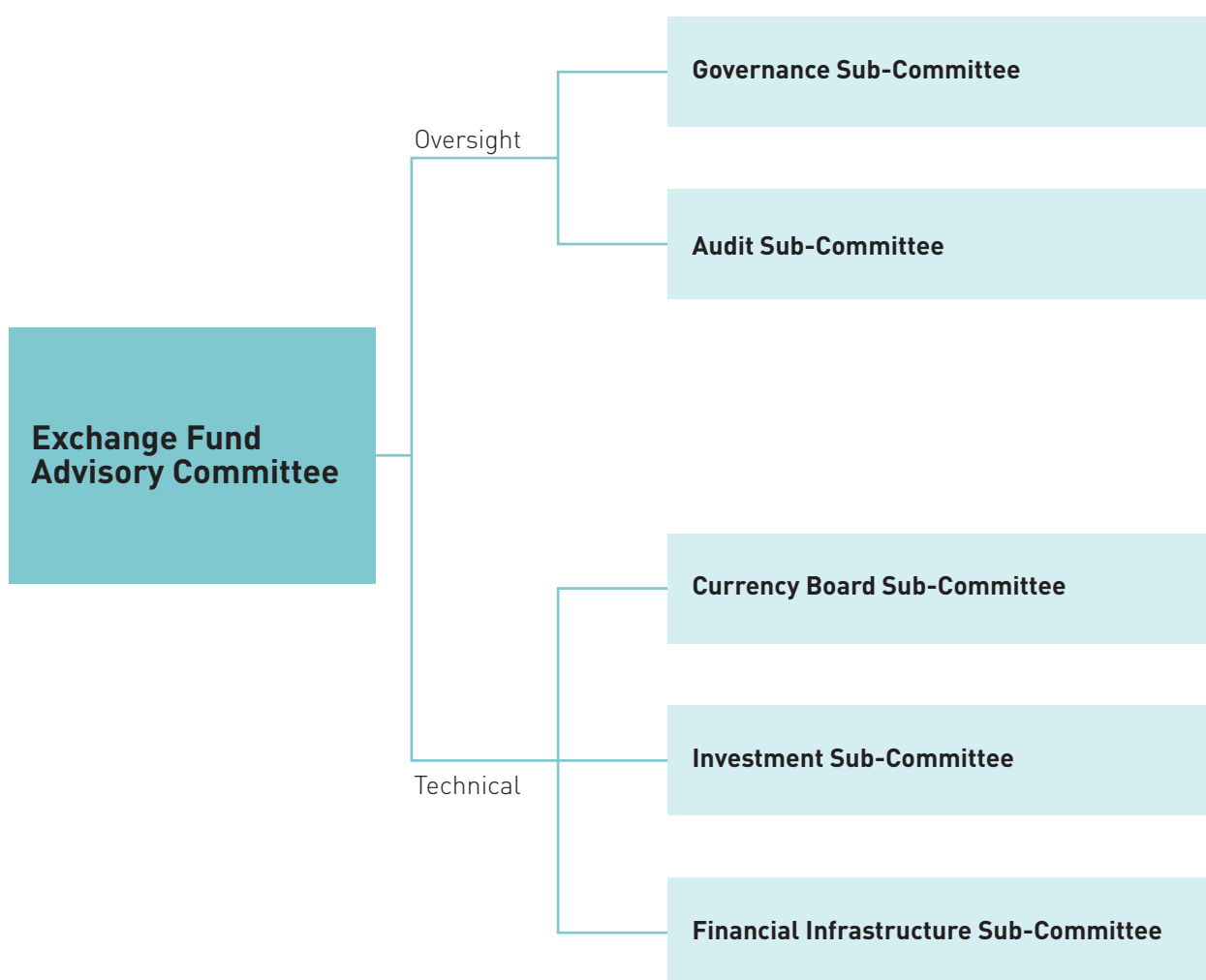
Deputy Vice-Chancellor
The University of Hong Kong
(until 31 December 2006)

Dr The Hon. David LI Kwok-po, LLD, GBS, JP

Chairman and Chief Executive
The Bank of East Asia Limited
(until 30 September 2006)

Secretary**Mr Trevor KEEN**

EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

Dr The Hon. Marvin CHEUNG Kin-tung,

DBA Hon., SBS, JP

Members

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

(Mr Cheng was Chairman at meetings in the absence of Dr Cheung)

The Hon. Victor LO Chung-wing, GBS, JP

Chairman and Chief Executive

Gold Peak Industries (Holdings) Limited

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer

Johnson Electric Holdings Limited

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, JP

Vice-Chairman and Managing Director

Sun Hung Kai Properties Limited

Professor Richard Y C WONG, SBS, JP

Deputy Vice-Chancellor

The University of Hong Kong

(until 31 December 2006)

Secretary

Mr Trevor KEEN

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.

THE EXCHANGE FUND ADVISORY COMMITTEE AUDIT SUB-COMMITTEE

Chairman

Dr The Hon. Marvin CHEUNG Kin-tung,

DBA Hon., SBS, JP

Members

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

Mr Simon IP Sik-on, JP

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

(from 3 October 2006)

(Mr Fan was Chairman at meetings in the absence of Dr Cheung)

Dr The Hon. David LI Kwok-po, LLD, GBS, JP

Chairman and Chief Executive

The Bank of East Asia Limited

(until 30 September 2006)

Secretary

Mr Trevor KEEN

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.

THE EXCHANGE FUND ADVISORY COMMITTEE CURRENCY BOARD SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

Mr William RYBACK, JP
Deputy Chief Executive
Hong Kong Monetary Authority

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

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr John GREENWOOD
Group Chief Economist
INVESCO Asset Management Limited

Professor TSANG Shu-ki
Department of Economics
Hong Kong Baptist University

Professor K C CHAN, JP
Dean of Business and Management
Hong Kong University of Science and Technology

Mr Peter WONG Tung-shun, JP
Chairman
The Hong Kong Association of Banks

Professor Richard Y C WONG, SBS, JP
Deputy Vice-Chancellor
The University of Hong Kong
(until 31 December 2006)

Dr The Hon. David LI Kwok-po, LLD, GBS, JP

Chairman and Chief Executive
The Bank of East Asia Limited
(until 30 September 2006)

Secretary

Mr Trevor KEEN

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.

THE EXCHANGE FUND ADVISORY COMMITTEE INVESTMENT SUB-COMMITTEE

Chairman

Mr Joseph Yam, GBS, JP

The Monetary Authority

Members

Mr Y K CHOI, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Secretary

Mr Trevor KEEN

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.

THE EXCHANGE FUND ADVISORY COMMITTEE FINANCIAL INFRASTRUCTURE SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
USI Holdings Limited

Dr Patrick WANG Shui-chung, JP
Chairman and Chief Executive Officer
Johnson Electric Holdings Limited

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

Mr Vincent CHENG Hoi-chuen, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited

Dr Patrick FUNG Yuk-bun
Chairman and Chief Executive
Wing Hang Bank Limited
(from 3 October 2006)

Mr Peter SULLIVAN
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
(until 6 December 2006)

The Hon. Henry FAN Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited
(until 3 October 2006)

Dr The Hon. David LI Kwok-po, LLD, GBS, JP

Chairman and Chief Executive
The Bank of East Asia Limited
(until 30 September 2006)

Secretary

Mr Trevor KEEN

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.

THE BANKING ADVISORY COMMITTEE

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP

The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

The Hon. Frederick MA Si-hang, JP

Secretary for Financial Services and the Treasury

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Representing Bank of China (Hong Kong) Limited

Mr Peter WONG Tung-shun, JP

Executive Director

The Hongkong and Shanghai Banking Corporation Limited

Representing The Hongkong and Shanghai Banking Corporation Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

Representing Standard Chartered Bank (Hong Kong) Limited

Mrs Doreen CHAN HUI Dor-lam

President and Chief Executive Officer

CITIC Ka Wah Bank Limited

Mrs Mignonne CHENG

Head of North and East Asia

BNP Paribas

Dr The Hon. David LI Kwok-po, LLD, GBS, JP

Chairman and Chief Executive

The Bank of East Asia Limited

Ms Maria XUEREB

Financial Services Partner

Deloitte Touche Tohmatsu

Mr Ignatius CHAN Tze-ching, JP

Citigroup Country Officer, Hong Kong & Head of Greater China

Corporate and Investment Banking

Citibank, N.A.

Mr Hideo HIYAMA

Director, General Manager & Regional Chief Executive

Sumitomo Mitsui Banking Corporation

Hong Kong Branch

Mr James C K WONG

Chief Executive Officer

Dah Sing Life Assurance Company Limited

Mr Stanley Y F WONG

Director & Deputy General Manager

Industrial and Commercial Bank of China (Asia) Limited

(from 1 November 2006)

Mr Randolph G SULLIVAN

Chief Executive Officer

DBS Bank (Hong Kong) Limited

(until 30 September 2006)

Secretary

Ms Jasmin FUNG

(from 8 May 2006)

Ms Irene SY

(until 7 May 2006)

THE DEPOSIT-TAKING COMPANIES ADVISORY COMMITTEE

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP

The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

The Hon. Frederick MA Si-hang, JP

Secretary for Financial Services and the Treasury

Mr Martin WHEATLEY

Chief Executive Officer

Securities and Futures Commission

Representing the Securities and Futures Commission

Mr Geoffrey J MANSFIELD

Chairman

The DTC Association (The Hong Kong Association of Restricted Licence

Banks and Deposit-taking Companies)

Representing the DTC Association

Mrs Pamela CHAN WONG Shui, BBS, JP

Chief Executive

Consumer Council

Representing the Consumer Council

Ms Kitty IU Pui-pui

Managing Director

Scotiabank (Hong Kong) Limited

Mr Mervyn JACOB

Partner

Assurance, Financial Services Practice

PricewaterhouseCoopers

Mr Frank J WANG

Executive Director and Deputy Chief Executive

Wing Hang Finance Company Limited

Mr Erik Helge WEINER

Chairman & Chief Executive

JP Morgan Securities (Asia Pacific) Limited

The Hon. CHAN Kam-lam, SBS, JP

Member

Legislative Council

(from 1 June 2006)

Mr Michael CHANG Ming-yuen

Director

Fubon Credit (Hong Kong) Limited

(from 1 June 2006)

Mr CHOI Jong Ha

Managing Director and Chief Representative

KDB Asia Limited

(from 1 June 2006)

Mr Yasuhiro MATSUMURA

Chairman

Mitsubishi UFJ Securities (HK) Capital, Limited

(from 1 June 2006)

Dr Eric K C LI, GBS, JP

Senior Partner

Li, Tang, Chen & Co

Certified Public Accountants (Practising)

(until 31 May 2006)

Mr TAN Yoke-kong

General Manager

JCG Finance Company, Limited

(until 31 May 2006)

Secretary

Ms Jasmin FUNG

(from 8 May 2006)

Ms Irene SY

(until 7 May 2006)

Chief Executive's Committee



CHIEF EXECUTIVE

Joseph YAM, GBS, JP

Joseph Yam has served as Chief Executive of the HKMA since its establishment in April 1993. Mr Yam began his civil service career in Hong Kong as a Statistician in 1971, and became an Economist in 1976. His involvement in monetary affairs in Hong Kong started when he was appointed Principal Assistant Secretary for Monetary Affairs in 1982. He helped put together Hong Kong's Linked Exchange Rate system in 1983. He was subsequently appointed Deputy Secretary for Monetary Affairs in 1985 and Director of the Office of the Exchange Fund in 1991.



DEPUTY CHIEF EXECUTIVE

William RYBACK, JP

William Ryback is in charge of the full range of banking policy, development and supervision issues. Prior to joining the HKMA in 2003, Mr Ryback was Senior Associate Director of the Division of Bank Supervision at the Board of Governors of the Federal Reserve System in Washington, D.C.. He was also Chairman of the Board of Directors of the Association of Bank Supervisors of the Americas. He was the Board of Governors representative on the Basel Committee on Banking Supervision from 1986 to 1994.



DEPUTY CHIEF EXECUTIVE

Peter PANG, JP

Peter Pang is responsible for external affairs, corporate services and research. Mr Pang joined the HKMA as Executive Director (Banking Policy) in 1994 and was appointed Executive Director (Monetary Policy and Markets) in 1996. He was the Chief Executive Officer of the Hong Kong Mortgage Corporation from 1997 to 2004. He was appointed to his present position in July 2004. Mr Pang joined the civil service as an Administrative Officer in 1979 and served as Assistant Director General of Trade and Assistant Commissioner of Banking before joining the HKMA.



DEPUTY CHIEF EXECUTIVE

Y K CHOI, JP

Y K Choi is responsible for monetary management, financial infrastructure, reserves management, and strategy and risk. He joined the HKMA as Head (Banking Policy) in 1993 and was appointed Executive Director (Banking Supervision) in 1995 before being appointed to his present position in June 2005. Mr Choi joined the Office of the Commissioner of Banking in 1974. He became Assistant Commissioner of Banking in 1990 and was seconded to the Office of the Exchange Fund in 1991 with responsibility for currency stability and debt market development before joining the HKMA.



GENERAL COUNSEL

Stefan GANNON, JP

Stefan Gannon has been General Counsel of the HKMA since its establishment in 1993. A barrister, Mr Gannon was the Legal Adviser to the Monetary Affairs Branch of the Hong Kong Government from 1987 to 1993.



EXECUTIVE DIRECTOR (BANKING DEVELOPMENT)

Raymond LI, JP

Raymond Li is responsible for banking sector reform and development, licensing matters, enforcement on securities activities and oversight of clearing and settlement systems. Mr Li joined the Hong Kong Government as an Administrative Officer in 1982 and became Principal Assistant Secretary (Monetary Affairs) in 1990. He was appointed Head (Banking Development) at the HKMA in 1993 and took up the post of Head (Administration) in 1995. He was promoted to Executive Director (Banking Policy) in 1996. Before being appointed to his present position in June 2005, he was Executive Director (Corporate Services).



EXECUTIVE DIRECTOR (EXTERNAL)

Julia LEUNG, JP

Julia Leung is responsible for international affairs relating to multilateral agencies and central bank co-operation, China research, financial market integration issues, as well as the HKMA's overseas offices in New York and London. Ms Leung joined the HKMA in 1994 as Senior Manager. She was promoted to Division Head in 1996, and was appointed to her present position in April 2000.



EXECUTIVE DIRECTOR (BANKING POLICY)

Simon TOPPING, JP

Simon Topping is responsible for the development of banking supervisory policies on Basel II, risk management, anti-money laundering, accounting and disclosure, and consumer issues; for surveillance of banking sector performance; and for Hong Kong's representation in regional and international banking supervisory forums. He joined the HKMA in 1995 as a Division Head in the Banking Supervision Department and was appointed to his present position in September 2000. Prior to joining the HKMA he was with the Bank of England and the International Monetary Fund.



EXECUTIVE DIRECTOR (MONETARY MANAGEMENT AND INFRASTRUCTURE)

Eddie YUE, JP

Eddie Yue is responsible for monetary management and financial infrastructure. Mr Yue began his career as an Administrative Officer in the Hong Kong Government in 1986. He joined the HKMA in 1993 as a Senior Manager, and was subsequently promoted to Division Head in 1994. He has worked in a number of divisions, including Monetary Management, External Relations, and Banking Development, and has served as Administrative Assistant to the Chief Executive of the HKMA. Mr Yue was appointed Executive Director (Corporate Services) in June 2001 and to his present position in July 2004.



EXECUTIVE DIRECTOR (BANKING SUPERVISION)

Arthur YUEN, JP

Arthur Yuen is responsible for banking supervision. He joined the HKMA in 1996 as Head of Administration and has since taken up different responsibilities including research and liaison on Mainland China economic and market development issues before being appointed Head of Banking Supervision in 2000. He took up the position as Executive Director (Banking Development) in July 2004. He was appointed to his present position in June 2005. Before joining the HKMA, Mr Yuen worked in the Hong Kong Securities and Futures Commission for two years after having served as an Administrative Officer in the Hong Kong Government for over eight years.



EXECUTIVE DIRECTOR (RESEARCH)

Hans GENBERG

Hans Genberg is responsible for research on issues related to monetary policy and financial markets. He is also Director of the Hong Kong Institute for Monetary Research. He was professor of economics at the Graduate Institute of International Studies in Geneva, Switzerland since 1979, and for a number of years he was the Head of its Economic Section before joining the HKMA in early 2005. He has also been a visiting scholar at the International Monetary Fund and the World Bank. He has published widely on issues related to monetary and exchange rate policy.



EXECUTIVE DIRECTOR (STRATEGY AND RISK)

Edmond LAU, JP

Edmond Lau is responsible for examining and developing strategic responses to the impact on the HKMA's policies and operations of such processes as the globalisation and liberalisation of financial markets and technological change. Mr Lau joined the HKMA in 1997 as Head (Banking Development) and has been involved in banking reform and the establishment of the Deposit Protection Scheme. He took up the position as Administrative Assistant to the Chief Executive of the HKMA in 2004 after a one-year secondment to the Financial Services and Treasury Bureau. Before joining the HKMA Mr Lau was an Administrative Officer in the Hong Kong Government.



EXECUTIVE DIRECTOR (CORPORATE SERVICES)

Christopher MUNN, JP

Christopher Munn is responsible for corporate development, human resources, administration, finance and information technology. Mr Munn joined the HKMA in 1998 as Senior Manager (Corporate Development) and served as Head (Corporate Development) from 1999 to 2005.



EXECUTIVE DIRECTOR (RESERVES MANAGEMENT)

Francis CHU, JP

Francis Chu is responsible for the investment management of the Exchange Fund. Mr Chu joined the HKMA in 1995 as a Senior Manager in the Monetary Operations Division. He was promoted to Head (Monetary Operations) in 1996. From 2002 to 2004 he was the HKMA's Chief Representative in New York. Since returning to Hong Kong in 2004 he served again as Head (Monetary Operations) before his promotion to his current position. Before joining the HKMA, Mr Chu worked for more than 15 years in senior management and treasury positions in the banking sector in Hong Kong.



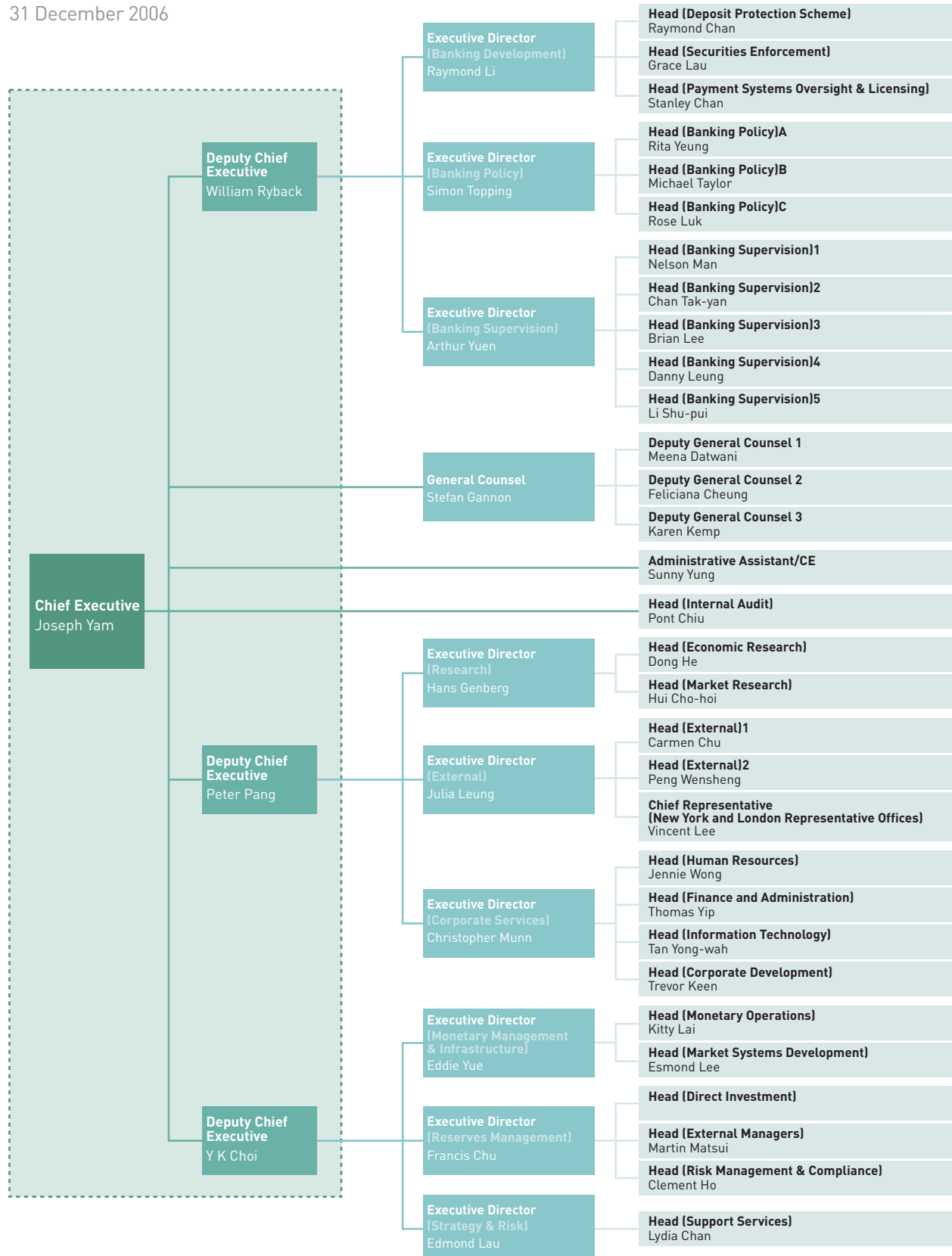
CHIEF EXECUTIVE OFFICER (HONG KONG MORTGAGE CORPORATION)

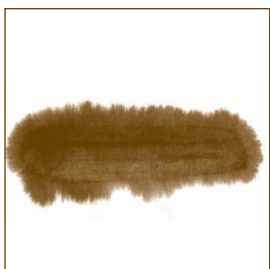
James H LAU Jr, JP

James Lau has been the Chief Executive Officer of the Hong Kong Mortgage Corporation since July 2004. Mr Lau joined the HKMA in 1993 and became Executive Director (External) in 1994 and Executive Director (Monetary Management and Infrastructure) in 2000. Mr Lau joined the Hong Kong Government as an Administrative Officer in 1979. He was Hong Kong's Deputy Permanent Representative to the GATT in Geneva from 1986 to 1990 before joining the Office of the Exchange Fund as Assistant Director (Monetary Management) in 1991.

HKMA Organisation Chart

31 December 2006





Economic and Banking Environment

For the third consecutive year, Hong Kong's economy has grown above its long-term trend-rate, underpinned by healthy growth in domestic demand and exports; and the outlook for 2007 remains favourable. The banking sector enjoyed another year of solid results despite the intensely competitive operating environment.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy grew above trend for the third consecutive year in 2006. Real GDP increased by 6.8% following remarkable growth of 7.5% in 2005 and 8.6% in 2004. Consumer spending and business equipment investment set the trend, while exports of goods and services put in solid performances (Table 1). Consumer price inflation picked up with the higher domestic demand and higher housing rents, although inflationary pressures were contained. Unemployment fell to its lowest point in six years.

Monetary conditions eased during the year with interest rates declining at both the wholesale and retail levels, reflecting abundant liquidity in the banking sector. Broad money and domestic credit picked up along with the increased economic activity. The loan-to-deposit ratio declined to a record low towards the end of the year.

Strong domestic demand

Private domestic demand rose briskly with the strong revival in consumer spending and business equipment investment. The steady rise in labour income and a strong rally in the stock market strengthened consumer confidence, pushing up private consumption by 5.1%

Table 1. GDP annual growth by expenditure components (%)

	2006					2005				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	4.8	5.4	4.4	5.8	5.1	3.7	2.5	4.0	3.1	3.3
Government Consumption Expenditure	1.1	-1.5	-1.1	2.4	0.3	-4.5	-2.3	-1.6	-3.9	-3.1
Gross Domestic Fixed Capital Formation	7.3	4.5	10.3	9.5	7.9	1.3	5.0	3.2	8.9	4.6
Change in Inventories ¹	1.3	0.7	-0.8	-0.2	0.2	-4.1	-3.2	0.7	2.7	-0.8
Net Exports of Goods ¹	0.2	-0.7	0.8	0.5	0.2	6.5	5.5	2.5	-0.7	3.3
Net Exports of Services ¹	2.1	1.6	2.3	1.6	1.9	2.0	2.8	2.4	2.5	2.4
GDP	8.0	5.5	6.7	7.0	6.8	6.3	7.5	8.4	7.8	7.5

¹ Percentage-point contribution to annual growth of GDP.

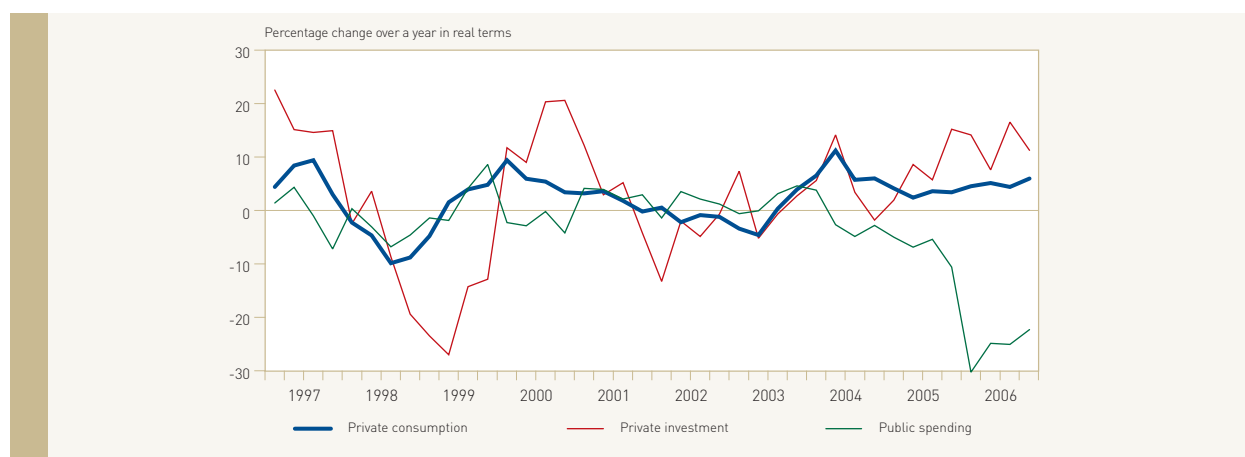
Source: Census and Statistics Department.

compared with 3.3% in 2005. Supportive monetary conditions boosted business investment, with growth in equipment spending rising by 17.2% compared with 12.9% in 2005, the fastest pace of expansion since 2000. However, construction spending remained subdued and the Government continued to cut its costs by reducing public expenditure (Chart 1).

Solid export growth

Exports of goods and services remained robust in 2006 with increased cross-border trade with the Mainland and solid import demand from other major trading partners, including the US and the European Union. Merchandise exports increased by 10.2% after rising by 11.2% in 2005, mainly driven by strong growth in re-exports. Mainland China remained Hong Kong's largest trading partner, followed by the US and European Union (Table 2).

Chart 1. Domestic demand



Source: Census and Statistics Department.

Table 2. Merchandise exports by major trading partners¹

	Share %	2006					2005				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	47	18	8	13	17	14	12	15	14	14	14
United States	15	4	0	1	7	3	6	7	8	2	6
European Union	14	9	4	2	6	5	22	20	16	13	17
Japan	5	7	2	0	-2	1	12	12	13	6	10
ASEAN5 ² + Korea	7	8	2	13	7	8	6	8	6	9	7
Taiwan	2	4	-7	9	7	3	-3	4	7	3	3
Others	10	11	7	9	17	11	5	7	15	5	8
Total	100	12	5	8	12	9	11	12	13	10	11

¹ Figures are percentage changes year on year except for major export markets' shares in Hong Kong's total exports.
² ASEAN5: the Philippines, Malaysia, Indonesia, Singapore and Thailand.

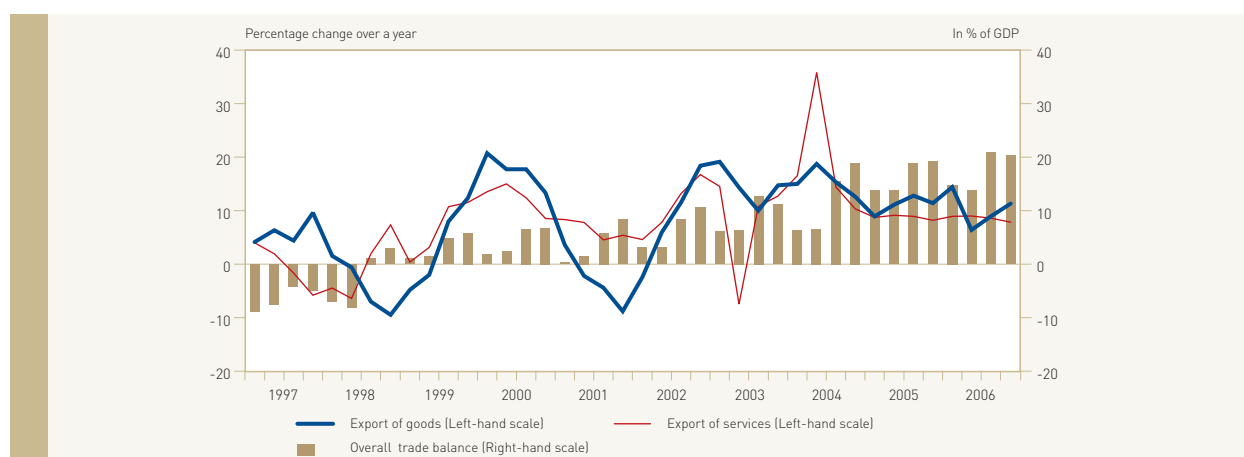
Source: Census and Statistics Department.

Retained imports of goods rose an impressive 8.0% compared with a 1.6% growth in 2005, reflecting the stronger domestic demand. The merchandise trade deficit in real terms narrowed to HK\$7.8 billion (0.4% of real GDP) in 2006 from HK\$11.4 billion (0.7% of real GDP) in 2005, as exports grew faster than imports. Benefiting from strong growth in trade intermediation, exports of services (particularly cross-border transportation and trade-related services) increased faster than imports of services, resulting in an overall trade surplus of HK\$303.6 billion (17.5% of real GDP), compared with HK\$269.5 billion (16.6% of real GDP) in 2005 (Chart 2).

Inflation rising slowly

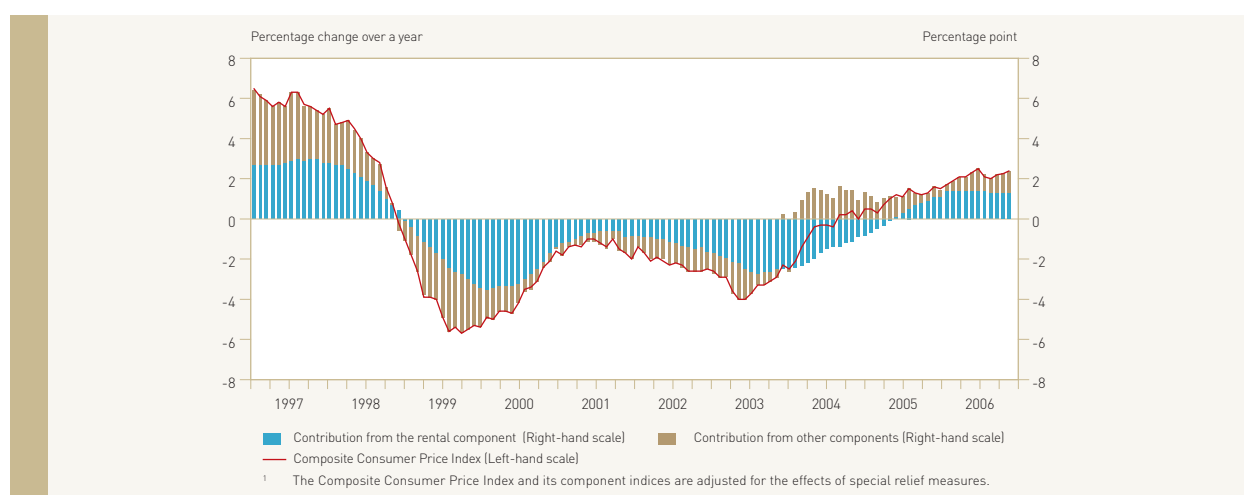
Consumer price inflation continued to rise gradually in 2006, reflecting robust growth in aggregate demand and higher housing costs feeding into the consumer price index. However, inflationary pressures remained contained. The Composite Consumer Price Index (CCPI) inflation rose to 2.0% from 1.0% in 2005, mainly as a result of higher residential rents (Chart 3). If the housing component is excluded, CCPI inflation eased to 0.9% from 1.1% in 2005, because of a fall in prices of non-food tradable goods, particularly durable goods, such as computers and home appliances, which declined by 6.4% in 2006 after falling 3.2% the previous year.

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



Source: Census and Statistics Department.

Chart 3. Consumer prices¹



Sources: Census and Statistics Department and staff estimates.

Improving labour market

Business expansion increased the demand for labour, further pushing down the seasonally adjusted unemployment rate from 5.2% in January to 4.4% in December, the lowest in six years. The fall in the unemployment rate was driven by faster growth in employment than in the labour force. This was most evident in the financial and social and personal service sectors (Chart 4).

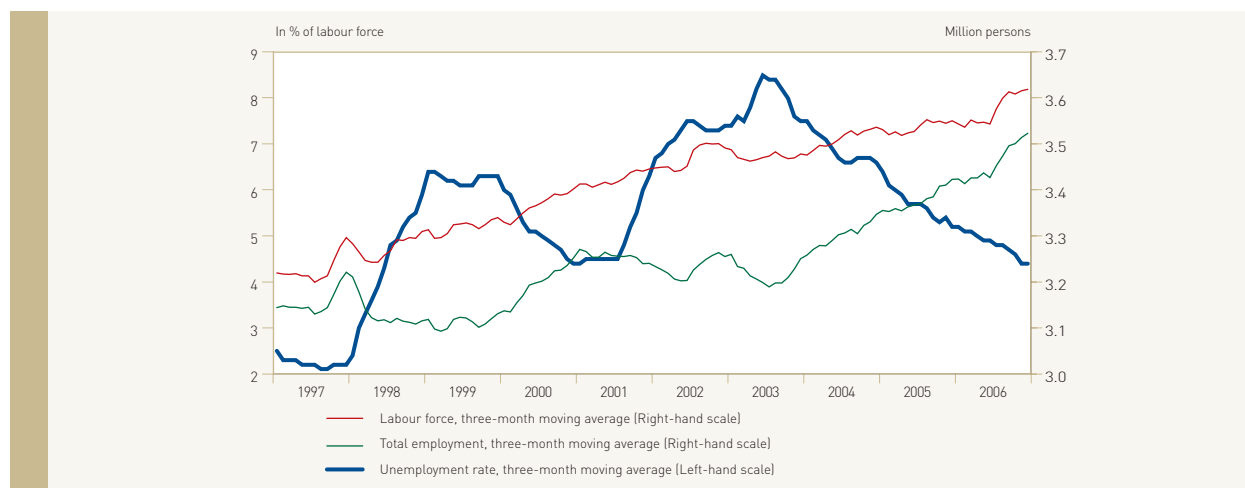
The continued expansion in employment led to increases in labour earnings. The nominal payroll per worker, which includes wages and other non-regular allowances

and bonuses, increased by 2.4% in 2006, after growing by 3.5% in 2005. However, unit labour costs remained largely stable, as the rise in labour productivity offset increased earnings.

Strong asset market performance

The residential property market picked up modestly during the year with house prices rising by 0.7% year on year in 2006 after rising by 17.9% in 2005. As private housing demand moderated, key property developers reduced the premium of house prices in the primary market over those in the secondary market to attract new home buyers. While prices of medium-sized residential flats remained largely stable during the year,

Chart 4. Labour market conditions



Source: Census and Statistics Department.

those for larger flats continued to pick up, with prices for luxury flats located in certain prime locations rising close to the peak levels of 1997. But there were no major signs of overheating in the property market. The stabilisation of house prices and intensified competition in the mortgage market stimulated residential property transactions in the second half of 2006, with the number of Sale and Purchase Agreements rising by 6.8% from the first half.

The local stock market staged a strong rally in the second half of 2006, supported by Hong Kong's robust economic performance, the pause in the monetary tightening cycle in the US and sizable capital inflows driven by increased initial public offering (IPO) activities. The Hang Seng Index climbed to a record high of 20,001

towards the end of the year. In 2006, the stock market increased by 34%, the largest annual gain since 2003. The H-share index had an even more dramatic rise of 94%, reflecting rising demand for shares of Chinese enterprises listed on the domestic market.

Notes and coins

At the end of 2006, the total value of banknotes in circulation was \$157,385 million, an increase of 5.4% from a year ago (Charts 5, 6, 7). The total value of government-issued notes and coins in circulation amounted to \$6,633 million, an increase of 2.3% (Charts 8 and 9). The value of \$10 notes issued by the Government in circulation reached \$1,515 million, an increase of 4.7% from 2005.

Chart 5. Banknotes in circulation by note-issuing banks at the end of 2006

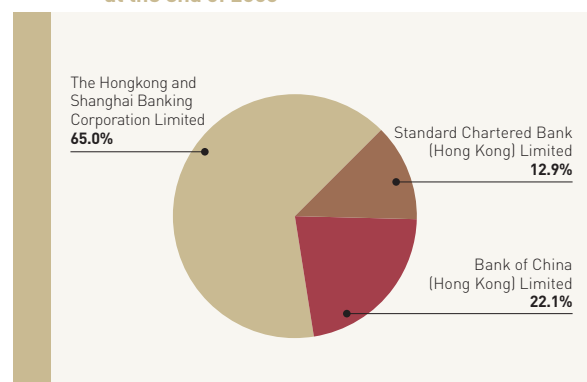


Chart 6. Distribution of banknotes in circulation at the end of 2006

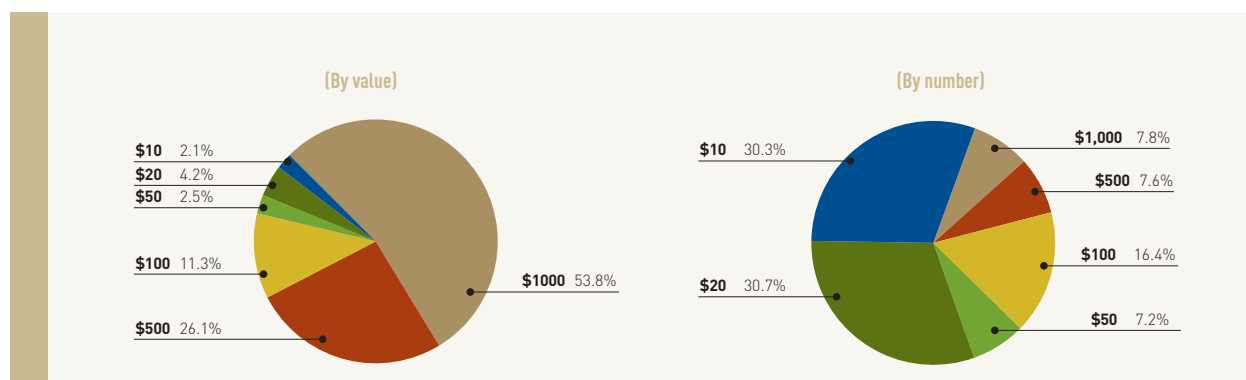


Chart 7. Banknotes in circulation at the end of year

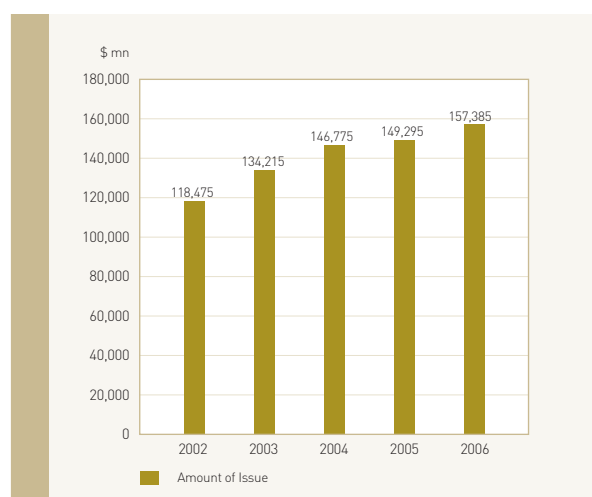
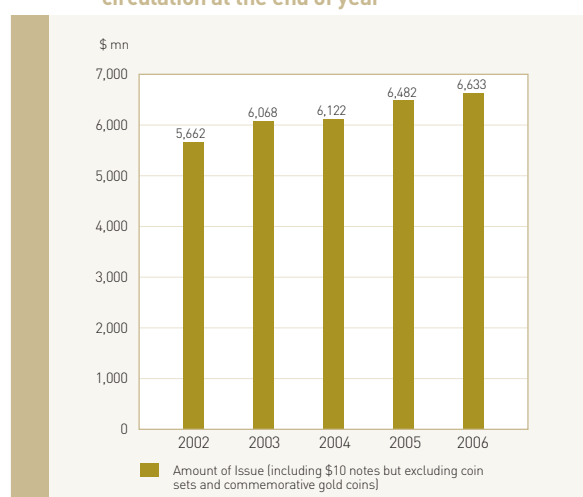


Chart 8. Government-issued notes and coins in circulation at the end of year



Hong Kong banknotes

The latest series of banknotes was issued in 2003/2004 by the three note-issuing banks. Additional security features are incorporated in the series to combat counterfeiting.

 > Consumer Information > New Hong Kong Banknotes

Public education programmes on the security features of banknotes continued to be well received. During the year, 37 seminars were organised for about 2,800 bank tellers, retail cashiers, moneychangers and cash-handling staff of chain stores and hotels. Participants found the seminars useful in providing them with knowledge and skills for authenticating banknotes. To promote

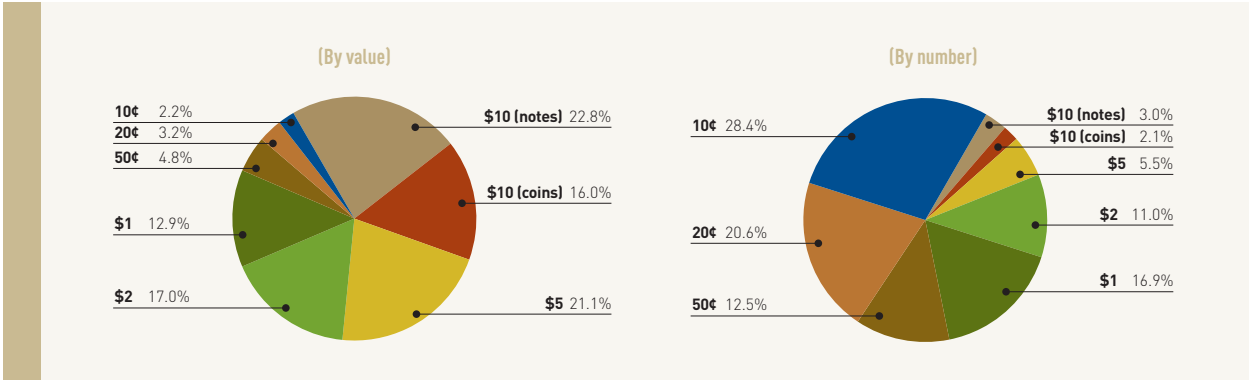
conservation and more cost-effective inventory management, the HKMA worked with the three note-issuing banks to encourage the public to use “good-as-new” notes instead of brand new ones for *lai see* (gifts at Chinese New Year). A naming and slogan competition held for primary school students saw the introduction of the new Chinese name, “ying-san note” (迎新鈔票), on posters as part of the campaign by the note-issuing banks to promote the use of “good-as-new” notes.

Coin replacement programme

The programme to withdraw coins bearing the Queen’s Head design continued. In 2006, 34 million coins were removed from circulation.

 > Consumer Information > Notes & Coins

Chart 9. Government-issued notes and coins in circulation at the end of 2006



OUTLOOK FOR THE ECONOMY

Favourable growth forecast

The outlook for 2007 remains favourable, as the Hong Kong economy will continue to benefit from the Mainland's strong economic performance given their close economic and financial ties. However, as global growth is expected to moderate in 2007, led by the slowdown in the US, a reduction in Hong Kong's export growth is likely. The market consensus is for real GDP growth to decline to 5.3% in 2007 from 6.8% in 2006, partly due to a moderation in growth in the economies of Hong Kong's main trading partners. Nevertheless, given a gradual appreciation of the renminbi and an expected weakening in the US dollar over the medium term, because of its sizable current account deficit and the halt in interest rate increases, the Hong Kong dollar effective exchange rate is likely to depreciate. This will offset part of the negative effect from weaker external demand. Domestic demand is expected to grow at a solid pace. Favourable labour market conditions and a steady rise in household income will continue to support consumer spending, while supportive monetary conditions will boost business investment.

Inflationary pressures to remain contained

Consumer price inflation is expected to pick up modestly in 2007, partly reflecting rising domestic demand and higher import prices against a general weakness in the US dollar and the continued appreciation of the renminbi. The market consensus is that CCPI inflation will increase to 2.3% in 2007 from 2.0% in 2006. But the risk of a

substantial rise is small. The recent moderation in house price inflation, if sustained, will restrain growth in residential rents, which have a weighting of more than one-quarter in the CCPI basket. On the supply side, there has been little upward pressure on unit labour costs, while the inflation rate of retained imports moderated to 5.0% in 2006 from 8.4% in 2005.

Uncertainties and risks

The benign economic outlook for Hong Kong is subject to a number of uncertainties, mainly reflecting risks from the external environment. First, housing market weakness in the US may be more prolonged than some recent indicators suggest. If this leads to a significant slowdown in domestic demand in the US, the export growth of its major trading partners will be reduced. This would have a particularly adverse effect on re-export trade between Hong Kong and the Mainland. Secondly, persistent underlying inflationary pressures in major economies could prompt further monetary tightening. If this occurred in the US, it would lead to tighter monetary conditions in Hong Kong given the Linked Exchange Rate system, and business spending growth might slow as a result. Thirdly, ample global liquidity and the recent strong rally in financial asset prices in emerging economies suggest that market participants may have under-priced the risks in these markets. Any sharp reversal in international capital flows could increase financial market volatility in Hong Kong, which may undermine consumer and business confidence. Finally, medium-term risk factors persist, such as sizable global

 > Statistics

Overall asset quality remained good despite the increase in new debt provisions. Although the quality of the credit card portfolio weakened slightly alongside higher levels

Sound profitability and asset quality, combined with high levels of liquidity and high levels of capital suggest the banking industry is well placed to continue to support economic growth.

Interbank and deposit rates increased

While Hong Kong dollar interest rates increased in 2006, ample liquidity in the banking system meant they did not reflect the full extent of the increases in the US Fed funds target rate during the year. One-month Hong Kong Interbank Offer Rate (HIBOR) rose to an annual average of 4.12% from 2.91% in 2005 and the one-month time deposit rate rose to 2.70% from 1.26% [Table 3]. However, after raising their best lending rates by 25 basis points in the first half of the year, banks reversed this rate increase in the fourth quarter to leave their best lending rates at either 7.75% or 8.00% — the same level as at the beginning of the year. Nevertheless, the average best lending rate was higher for the year as a

[illegible]

* Best lending rate refers to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

whole resulting in the spread between the annual average best lending rate and the annual average one-month HIBOR widening to 378 basis points compared with 320 basis points in 2005. In addition, the spread between the annual average best lending rate and the average one-month time deposit rate expanded to 520 basis points from 485 basis points.

Profitability trends

The aggregate pre-tax operating profits of the retail banks' Hong Kong offices increased by 10.1% (Chart 10), although the post-tax return on average assets fell to 1.35% from 1.40% in 2005 (Chart 11) as assets increased at a faster rate than profits.

The main contributor to profit growth was an increase in net interest income as a result of an expansion of assets and a recovery in interest margins, which widened to 1.80% from 1.68% in 2005 (Chart 12). By contrast, non-interest income grew at a slower rate in 2006 as most of the increase in income from fees and commissions was offset by a contraction in treasury income. Because of the faster increase in net interest income than non-interest income, the proportion of retail banks' non-interest income to total income decreased to 38.4% from 41.1%^r in 2005. The share of income from fees and commissions rose to 22.7% from 22.1% in 2005, while the share of income from treasury operations dropped to 7.7% from 9.0%^r in 2005. Retail banks' overall bad debt charge increased compared with 2005. Nevertheless, it was only a small proportion of average total assets, 0.01% compared with -0.01% (a net debt provision write-back) in 2005 (Chart 13).

Chart 10. Year-on-year growth in retail banks' operating profit before tax



Chart 12. Retail banks' net interest margin

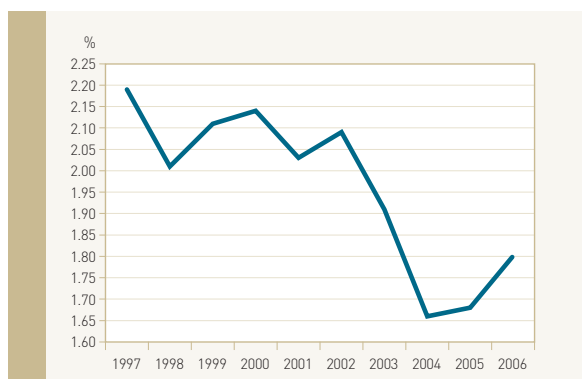


Chart 11. Retail banks' return on assets (after-tax profit)

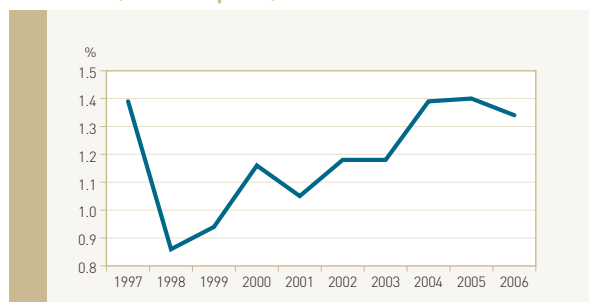
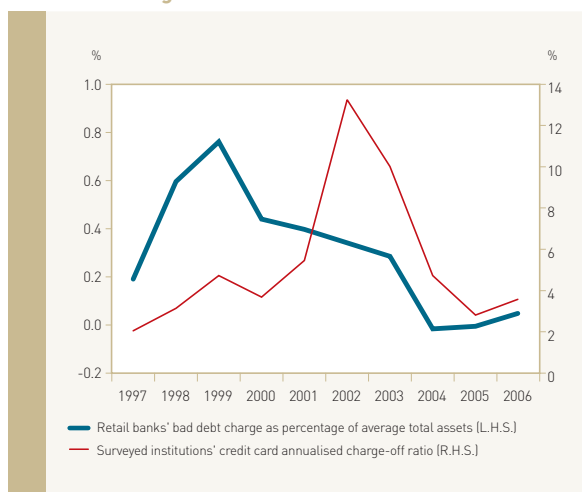


Chart 13. Charge-off ratios



^r Figure revised.

Operating costs continued to rise, due largely to increases in staff expenses caused by additional recruitment for business expansion and pay rises. There was also a general increase in other expenses relating to business expansion and system improvements. The faster increase in operating costs than in income resulted in an increase in retail banks' cost-to-income ratio to 42.7% from 41.8%^r in 2005 (Chart 14).

Balance sheet trends

Total assets of the banking sector and the retail banks expanded by 14.6% and 12.9% respectively. Retail banks' deposit liabilities also registered a sharp increase of 15.6%. The increase in deposits was more pronounced in the second half of the year.

Domestic loan demand higher

Retail banks' total lending rose by 4.0% in 2006. Domestic lending increased by 2.8% (Chart 15), mainly in property lending, share finance and trade finance, compared with an increase of 9.0%^r in 2005. Loans for use outside Hong Kong also rose by 29.1%.

Growth in property lending slowed to 2.1% from 7.6% in 2005. Within this trend, loans for property investment and property development increased by 5.5% and 9.7% respectively, compared with 17.1% and 14.0%^r in 2005. Residential mortgage loans decreased by 0.9% following an increase of 2.2%^r in 2005.

Trade-financing loans rose by 8.1% following an increase of 10.2%^r in 2005. However, loans to the manufacturing sector fell by 1.5% after an increase of 11.7%^r in 2005. Lending to the wholesale and retail trade sector grew by 7.6%. Because of the buoyant conditions in the domestic stock market and a number of large-scale IPOs in the second half of the year, loans to stockbrokers increased by 28.2%, following a decline of 0.1% in 2005. Loans to non-stockbroking companies and individuals to purchase shares also rose by 32.5% following an increase of 42.8%^r in 2005. Lending to the information technology sector decreased by 12.9%, with much of the decrease attributable to lending to the telecommunication sector, which fell by 16.4% after increasing by 23.8%^r the previous year. Lending to the electricity and gas sector also decreased, by 13.1%.

Chart 14. Retail banks' cost-to-income ratio

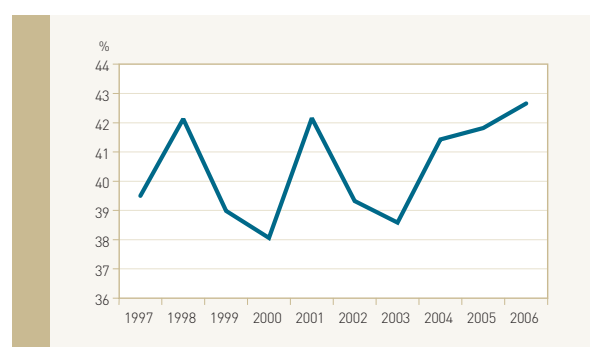
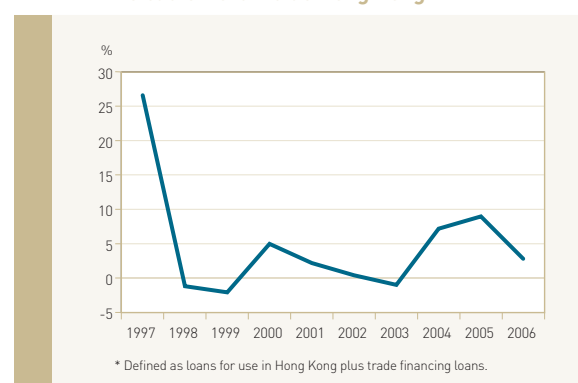


Chart 15. Retail banks' year-on-year growth of loans to customers inside Hong Kong*



^r Figure revised.

Credit card lending expanded. According to the regular survey of authorized institutions active in credit card business, total credit card receivables rose by 6.1% after an increase of 14.9% in 2005. The increase was largely due to festive spending and payment of salary tax by credit card at the end of 2006.

Following the adoption in the third quarter of a revised reporting framework for non-bank China exposures, retail banks' non-bank China exposures stood at \$420.2 billion, or 7.2% of their total assets at the end of 2006. This compared with \$142.1 billion^r (2.8% of total assets) reported under the old framework at the end of 2005. For the banking sector as a whole, the exposures were \$545.7 billion (5.9% of total assets).

Holdings of negotiable debt instruments increase

The high levels of liquidity in the banking system were reflected by increased holdings of negotiable debt instruments (NDIs, excluding negotiable debt certificates of deposits (NCDs)). Holdings of NDIs by retail banks grew at a rate of 23.2% compared with 6.2%^r in 2005. NDIs denominated in Hong Kong dollars increased by

33.6% and foreign currency NDIs by 18.1% [Chart 16]. A majority of NDIs (54.6%) were issued by corporates, while 24.2% were issued by governments and 21.2% by banks [Chart 17]. The share of retail banks' total holdings of NDIs to their total assets increased to about 24% at the end of 2006 from 22% a year ago.

By contrast, outstanding NCDs issued decreased by 12.7% in 2006 after rising 1.6% in 2005. The proportion of outstanding NCDs held by retail banks fell to 26.4% at the end of 2006, compared with 26.9% a year ago.

Customer deposits expand

Retail banks' customer deposits expanded by 15.6% after increasing 3.1% in 2005 [Chart 18]. Most of the increase, particularly in Hong Kong dollar deposits, took place in the second half of the year. With the 19.2% increase in Hong Kong dollar deposits [Chart 19] outweighing the 10.6% increase in foreign currency deposits, the proportion of Hong Kong dollar deposits to total deposits increased to 61% from 59% at the end of 2005. Deposit growth tended to be greatest at shorter maturities, reflecting the increased transaction demand for money

Chart 16. Negotiable debt instruments held by retail banks (currency breakdown)

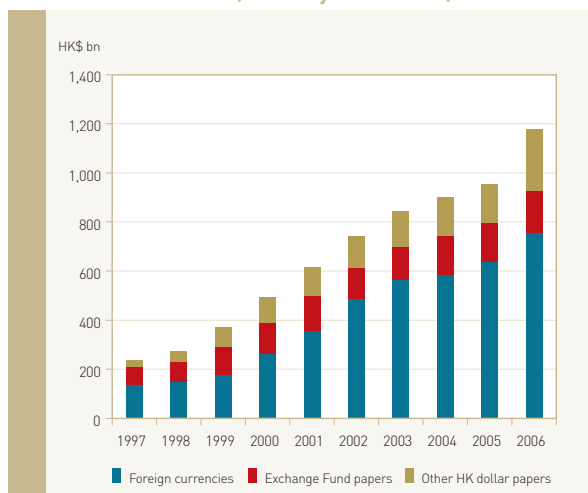
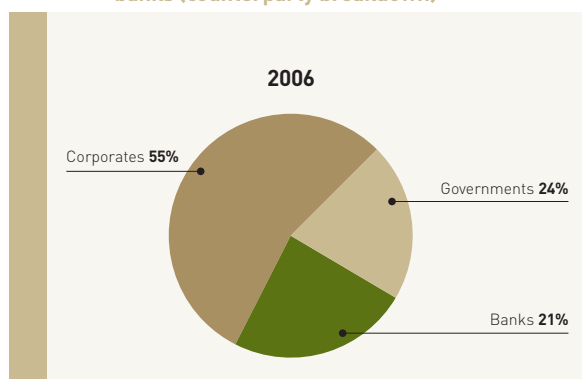


Chart 17. Negotiable debt instruments held by retail banks (counterparty breakdown)



^r Figure revised.

arising from the strong domestic stock market and IPO activities in 2006. Demand deposits recorded an increase of 17.2% after a decrease of 17.0% in 2005, while savings deposits increased by 19.3% following a decrease of 21.2% in 2005. However, growth in time deposits slowed to 13.3% compared with 30.1% in 2005. At the end of 2006, savings and demand deposits together accounted for 42.3% of total deposits, up from 41.1% a year ago.

Retail banks remain highly liquid

With deposits increasing at a much faster rate than loans, retail banks remained highly liquid in 2006. Their loan-to-deposit ratios in all currencies and in Hong Kong dollars both decreased to 47.9% from 53.2% and to 69.1% from 78.8%, respectively.

Improvement in asset quality continues

The asset quality of retail banks continued to improve with all major problem-loan ratios declining compared with a year ago. The classified loan ratio and the ratio of loans overdue for more than three months dropped to new lows of 1.11% and 0.54% respectively from 1.37%^r and 0.68%^r at the end of 2005. With both the overdue and the rescheduled loan ratios decreasing, the combined ratio of overdue and rescheduled loans decreased to 0.80% from 0.92% (Chart 20).

The asset quality of banks' residential mortgage portfolios continued to hold up well with the mortgage delinquency ratio staying at a low level of 0.20% and the rescheduled loan ratio declining to 0.26% from 0.35% at the end of 2005 (Chart 21). The quality of the mortgage

Chart 18. Year-on-year growth in retail banks' total customer deposits



Chart 19. Year-on-year growth in retail banks' Hong Kong dollar deposits*



^r Figure revised.

portfolio was underpinned by increased property values, improved labour market conditions and higher household income levels.

In line with the increase in property values, the outstanding number of residential mortgage loans in negative equity decreased by 23.1% to about 8,400 cases by the end of 2006 from some 11,000 cases at the end of 2005. Compared with the peak of 106,000 cases in June 2003, the number of negative equity cases has fallen by 92%.

In parallel with the increase in the number of bankruptcy petitions in 2006, the overall quality of banks' credit card portfolios weakened slightly. The credit card charge-off ratio for the year rose to 2.91% from 2.81% in 2005 (Chart 13), and the credit card delinquency ratio remained stable at 0.37% (Chart 21). Together with the

outstanding rescheduled credit card receivables, which fell to \$52 million from \$60 million at the end of 2005 (0.1% of total receivables within the card portfolio), the combined delinquent and rescheduled ratio declined to 0.44% at the end of the year.

 > [Press Releases](#) > [Residential Mortgage Survey](#)

 > [Press Releases](#) > [Credit Card Lending Survey](#)

Strong capital ratio

As growth in capital base outpaced that of risk-weighted assets, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions increased to 15.0% at the end of 2006, well above the statutory minimum of 8% (Chart 22).

As a result of a faster increase in risk-weighted assets, the tier-one capital adequacy ratio decreased to 13.1% at the end of 2006, compared with 13.3% at the end of 2005 (Chart 22).

Chart 20. Retail banks' gross classified loans and combined overdue and rescheduled loans as a percentage of total loans

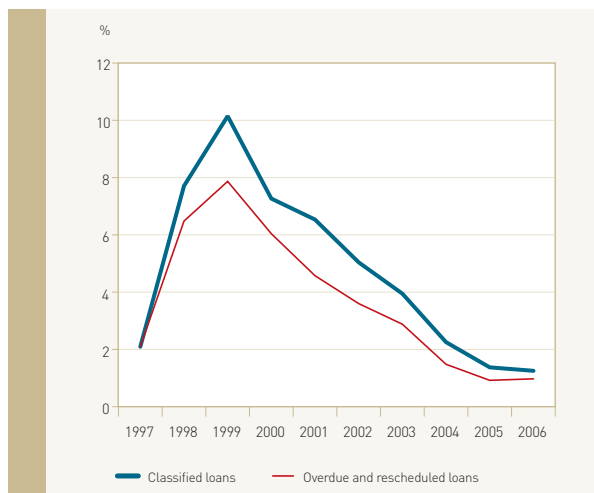
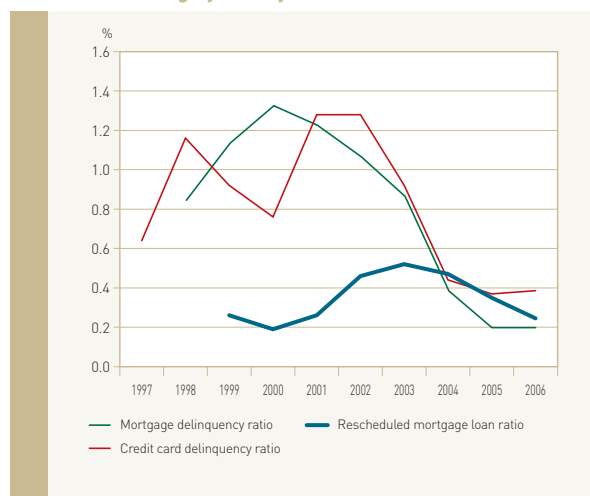


Chart 21. Asset quality of credit card and mortgage lending by surveyed institutions



PROSPECTS FOR 2007

The banking sector remains well capitalised, highly liquid, and financially resilient with good asset quality. The recovery in the net interest margin during 2006 is likely to be important in underpinning future profitability, while high levels of liquidity and capital give banks a sound platform to continue to support economic growth. In addition, the benefits of the new Basel II capital adequacy regime should start to become apparent in 2007, particularly in the substantial up-grading of banks' risk management practices which the new framework involves.

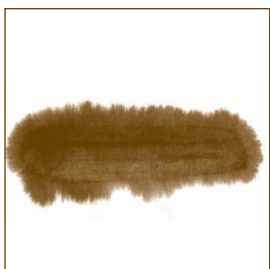
Despite these many positives, there are, however, a number of risks that will require close monitoring. The ample liquidity conditions experienced in 2006 may not persist throughout 2007. While banks are sufficiently liquid to absorb the consequences of any large-scale outflow of funds, a change in the direction of capital flows will have implications for domestic interest rates and, consequently, for asset quality. Banks need to monitor their interest rate risks and to assess the impact of any sudden shift in domestic interest rates on their main borrowers and asset classes.

Ample liquidity has also encouraged intense competition in some markets, for example for residential mortgage loans. If current levels of liquidity persist, banks will need to remain vigilant that the resulting competition for lending does not drive margins below an adequate risk-adjusted return or that it does not lead to excessive relaxation of credit underwriting standards. If demand for IPO-related lending, which accounted for a substantial part of domestic loan growth in 2006, slackens in the year ahead, competition in other markets may become more intense.

Finally, banks are likely to continue to look for profit opportunities outside Hong Kong during 2007, including the Mainland. Such expansion partly reflects the commercial reality that Hong Kong is now a mature banking market and, as such, returns may be modest compared with those that can be made elsewhere. Nonetheless, cross-border expansion places a particularly high premium on banks' ability to identify, manage and control the associated risks.

Chart 22. Consolidated capital adequacy ratio of all locally incorporated AIs





Monetary Stability

Hong Kong's foreign exchange and money markets were stable in 2006, with ample interbank liquidity, Hong Kong dollar interbank interest rates stayed below their US dollar counterparts throughout the year. The benign conditions meant that the Convertibility Undertakings were not triggered and the HKMA did not carry out any discretionary monetary operations. The market remained calm even when the renminbi appreciated beyond the Hong Kong dollar weak-side Convertibility Undertaking.

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, at around HK\$7.80 to US\$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Hong Kong dollar Monetary Base to be at least 100 per cent backed by US dollar reserves held in the Exchange Fund, and changes in the Monetary Base to be 100 per cent matched by corresponding changes in the US dollar reserves.

The Monetary Base 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.

 > Monetary Base

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest-rate adjustment mechanism. When the demand for Hong Kong dollars decreases and the market exchange rate weakens to the weak-side convertibility rate of HK\$7.85

per US dollar, the HKMA stands ready to purchase Hong Kong dollars from banks. The Aggregate Balance will then contract, driving up Hong Kong dollar interest rates to induce capital inflows to restore exchange-rate stability. On the other hand, if there is an increase in the demand for Hong Kong dollars and the market exchange rate strengthens to the strong-side convertibility rate of HK\$7.75 per US dollar, the HKMA will sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will expand to push down Hong Kong dollar interest rates, creating monetary conditions that counteract the original inflows.

 > Monetary Stability > Currency Board System

REVIEW OF 2006

Hong Kong's foreign exchange and money markets were stable in 2006. Since the introduction of the three refinements to the Linked Exchange Rate system in May 2005, the Hong Kong dollar spot exchange rate has fluctuated between the central parity rate of 7.8 and the strong-side Convertibility Undertaking of 7.75, reflecting buoyant stock market activities, which raised equity-related demand for Hong Kong dollars (Chart 1).¹

The Hong Kong dollar spot exchange rate moved within a narrow range of 7.7510–7.7622 from January to April. Driven by interest carry trade taking advantage of the widening negative gaps between Hong Kong dollar interest rates and their US dollar counterparts, the Hong Kong dollar exchange rate weakened gradually from 7.7514 in May to 7.7946 in early October. Thereafter, the exchange rate strengthened towards the end of the year to close at 7.7763 on 29 December, mainly because of equity-related inflows. The market remained calm when the renminbi spot rate appreciated beyond the Hong

¹ In 2006 a record \$525 billion was raised on the stock market, including a series of H-share IPOs amounting to \$292 billion.

Kong dollar weak-side Convertibility Undertaking of 7.85. This was the first indication of an apparent decoupling of the Hong Kong dollar spot exchange rate and the renminbi spot rate.

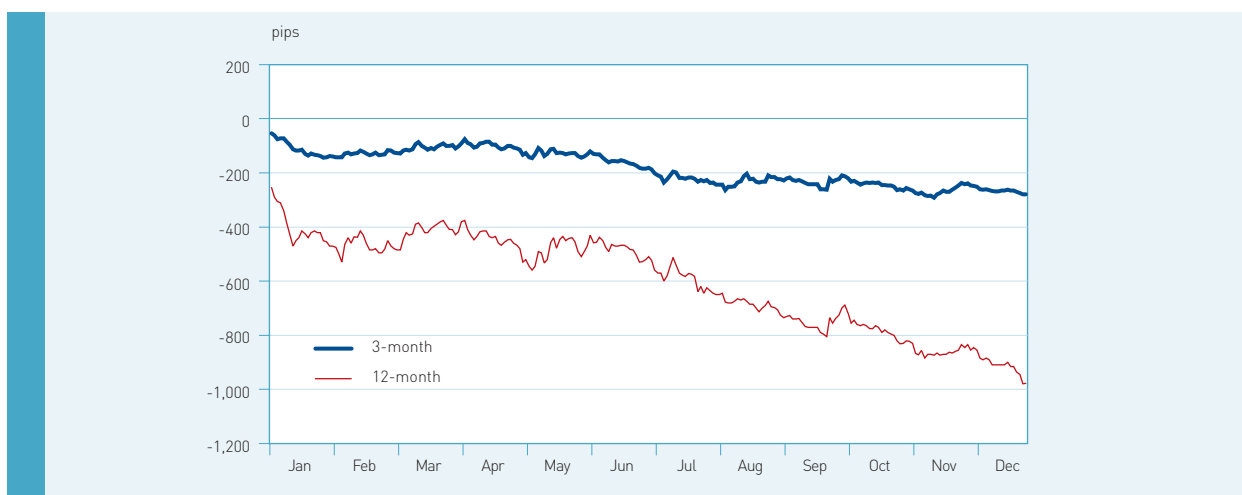
In 2006 the Hong Kong dollar forward discount stabilised from January to May, but widened towards the end of the year (Chart 2). For 12-month contracts, the Hong Kong dollar forward points widened to -977 pips on 29 December, after fluctuating around -440 pips in the first five months of the year, consistent with the interest rate differentials.

Movements in the Hong Kong dollar interbank interest rates largely tracked their US dollar counterparts (Chart 3). The Hong Kong Interbank Offered Rates (HIBORs) rose in the first half of the year, in line with increases in the US federal funds target rate. With the pause in interest-rate increases by the Fed from August, Hong Kong dollar interest rates eased and stayed steady, moving between four and five per cent. However, there were small short-term fluctuations, partly induced by equity initial public offerings (IPOs). On 29 December, the one-month and three-month HIBORs were 3.90% and 3.88% respectively.

Chart 1. Market exchange rate, January-December 2006



Chart 2. Hong Kong dollar forward points, January-December 2006



The ample interbank liquidity caused Hong Kong dollar interbank interest rates to stay below their US dollar counterparts throughout 2006. The negative interest rate differentials, starting from around 30 basis points, rose to around 140 basis points at the end of the year (Chart 4). The negative interest rate spreads in 2006 were not large compared with substantial capital inflows in the past. From a macroeconomic perspective, monetary conditions in the past year were broadly neutral. However, the risk of a sudden increase in local interest rates still exists.

The Convertibility Undertakings were not triggered and the HKMA did not carry out any discretionary monetary operations in 2006. As a result, the Aggregate Balance remained stable at around \$1.3 billion throughout the year (Chart 5). The interbank market worked smoothly even when some large and highly over-subscribed equity IPOs caused a surge in demand for interbank funds. There were small fluctuations in the Aggregate Balance because of time lags between the payment of interest on Exchange Fund paper and the issuance of additional Exchange Fund paper to absorb these payments.

Chart 3. HIBORs and LIBORs, January–December 2006

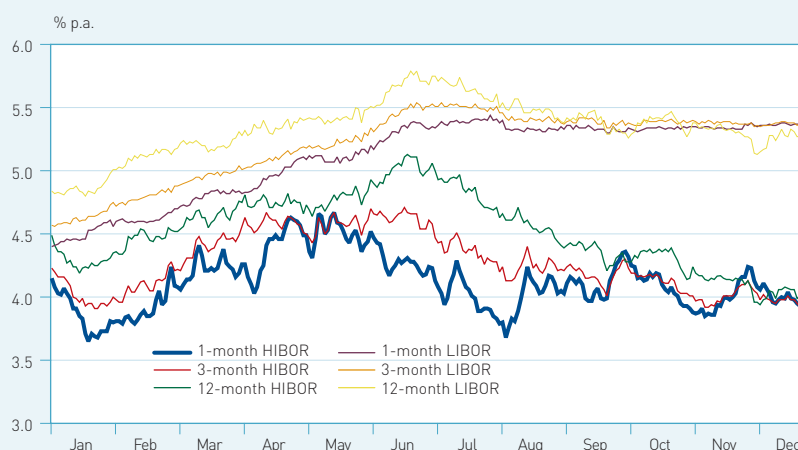
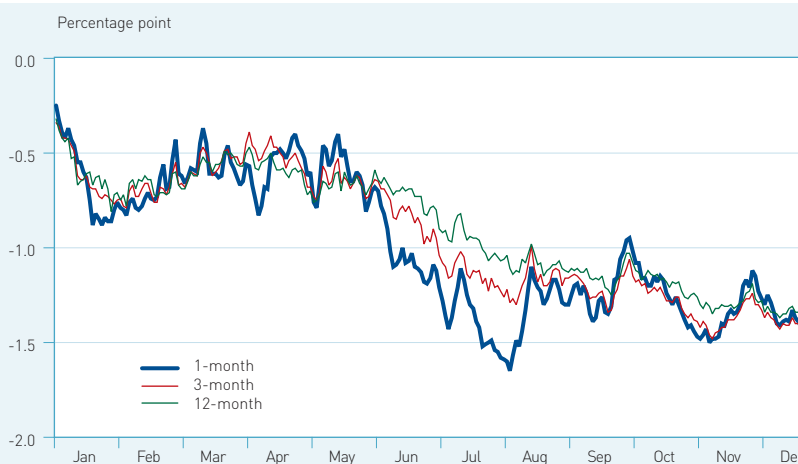


Chart 4. HK dollar - US dollar interest rate differentials, January–December 2006



Reflecting the smooth functioning of the Discount Window and the Linked Exchange Rate system, interest rate volatility, measured by the standard deviation of daily changes in one-month interbank interest rates (relative to the annual average), remained low. The overnight interbank interest rate, which is probably the most volatile among different tenors, did not exceed the Base Rate of the Discount Window in 2006.

A specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998 to improve the transparency of the Currency Board

Account. On 27 January 2006, the Backing Ratio, specified as the Backing Assets over the Monetary Base, declined to 110.76% due to increases in Certificates of Indebtedness ahead of the Chinese New Year holidays (Chart 6). Following this, and underpinned by decreases in the Monetary Base, the Backing Ratio gradually rose to the Upper Trigger Level of 112.5%. Under the arrangements approved by the Financial Secretary in 2000, a portion of the Backing Assets was re-allocated to the Investment Portfolio, restoring the Backing Ratio to around 110% on 14 July. Thereafter, the Backing Ratio moved steadily upwards as revaluation gains more than

Chart 5. Aggregate Balance, January-December 2006

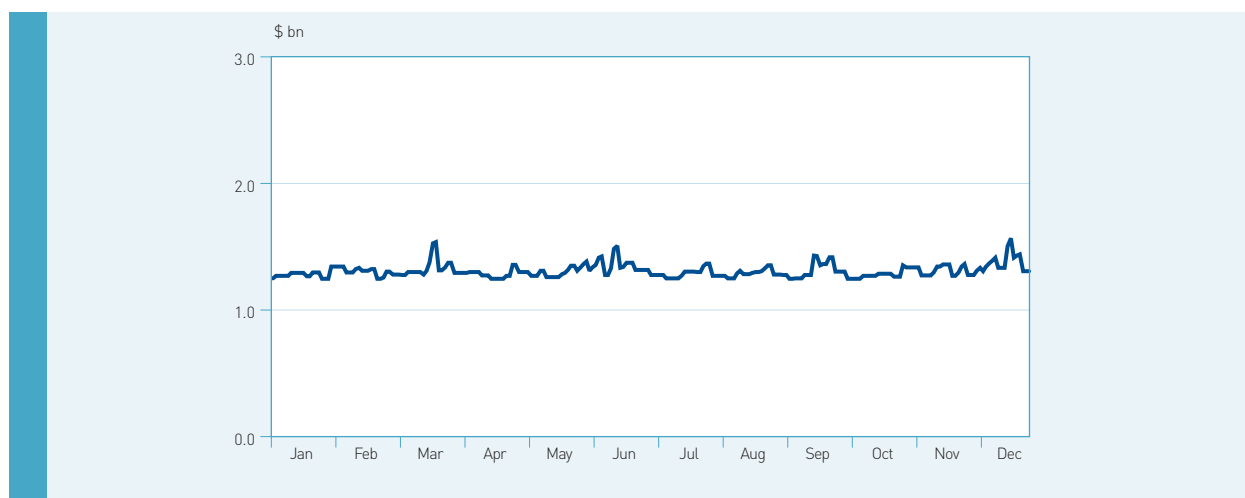
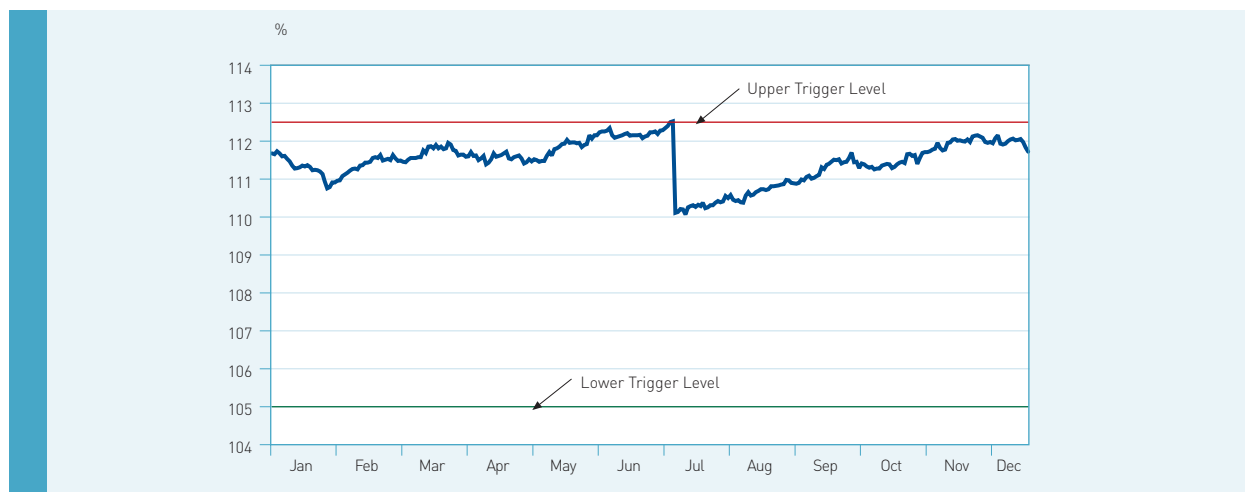


Chart 6. Daily movement of the Backing Ratio, January-December 2006



offset the effect of an increase in the Monetary Base. The Backing Ratio stood at 111.72% on 29 December 2006.

Activities at the HKMA

The EFAC Currency Board Sub-Committee, established in August 1998, monitors and reviews issues essential to monetary and financial stability. In 2006, these included an empirical framework of Hong Kong's best lending rates, the demand for narrow money and broad money, an indicator approach to forecasting the non-rental component of the Composite CPI in Hong Kong, relaxation of the three-year-tenor restriction on multilateral development banks' issuance of debt securities, Hong Kong's business cycle synchronisation with the US and Mainland China, structural determinants of Hong Kong's current account surplus, and the potential size and impact of outward portfolio investment from the Mainland.

 > Press Releases > Monetary Policy

The Hong Kong Institute for Monetary Research has continued to sponsor research in the fields of monetary policy, banking and finance. During the year, the Institute hosted 16 full-time and three part-time research fellows. It also published 19 working papers, one occasional paper, and one book in conjunction with the International Monetary Fund.

The Institute co-organised two international conferences. The first, held in July with the International Journal of Finance and Economics, looked at different aspects of international financial markets and the macro-economy; the second, in December with the Bank for International Settlements' Representative Office for Asia and the Pacific, reviewed the development of bond markets in Asia, Europe and Latin America. In April, the Institute sponsored a three-day workshop on building and solving

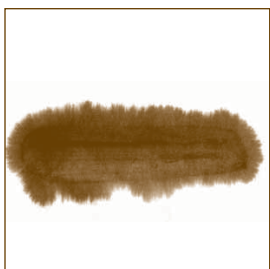
macro-econometric models by Professor Richard Pierse from Surrey University with participants from six central banks in the region. Other programmes included the Fourth Summer Workshop and a two-day workshop on issues related to the Mainland's rapid urbanisation. The Institute also organised 37 public seminars on a broad range of economic and monetary issues.

 > Links > HKMA-related Organisations > Hong Kong Institute for Monetary Research (HKIMR)

 > Research Memorandums

PLANS FOR 2007 AND BEYOND

The HKMA continually monitors risks and vulnerabilities in the domestic and external environment. Two sources of risk and vulnerability warrant special attention in 2007. First, ample liquidity in the local money market has led to persistent negative spreads of domestic interest rates relative to the corresponding US interest rates. In a currency board arrangement such spreads are expected to narrow over time. While the narrowing of spreads is likely to be smooth, it is not impossible that a sudden reversal of fund flows might lead to an abrupt increase in local interest rates and consequentially rapid adjustments in other local asset prices. Secondly, despite the decoupling of the Hong Kong dollar and renminbi spot exchange rates in 2006, further appreciation of the renminbi may have a more significant impact on local financial markets than has been the case so far if it begins to influence flows of funds into and out of the Asian region. The EFAC Currency Board Sub-Committee will continue to study issues relevant to Hong Kong's monetary and financial stability, including the role of Hong Kong as an international financial centre and Hong Kong's economic integration with the Mainland, keep the technical aspects of the Currency Board arrangements under review and, where appropriate, recommend measures to strengthen them.



Banking Stability

A major objective of the HKMA is to promote the safety and stability of the banking system through the regulation of banking and deposit-taking businesses and the supervision of authorized institutions. In 2006 the HKMA continued to improve its banking supervisory approach by using more benchmarking reviews to identify the best risk management and internal control practices for selected businesses of the banking industry. With increasing competition in the industry, particular attention was paid to the ability of Als to properly manage the risks arising from aggressive pricing strategies for their residential mortgage business. Preparations were completed for the implementation of Basel II in January 2007.

OBJECTIVES

The responsibility for promoting the safety and soundness of the banking system is shared among three departments within the HKMA:

- the Banking Supervision Department handles the day-to-day supervision of authorized institutions (Als)¹
- the Banking Policy Department formulates supervisory policies to promote the safety and soundness of the banking sector
- the Banking Development Department formulates policies to promote the development of the banking industry.

REVIEW OF 2006

Risk-based supervision

During the year the HKMA further developed its risk-based supervisory approach, allocating more resources to thematic examinations of selected Als. These examinations allowed the HKMA to benchmark Als' risk management and internal control practices on important business lines and major risk areas. They also helped identify emerging risks common to the examined Als and enabled the HKMA to issue guidance on sound industry practices in these areas.

A total of 247 on-site examinations were performed in 2006. Of these, 111 were thematic examinations: 25 to assess Als' compliance with the business restrictions on renminbi business; 17 on Als' implementation of the standardized (credit risk) approach and the Internal Ratings-Based (IRB) approach under Basel II; 22 on Als' anti-money-laundering and counter-terrorist-financing (AML/CFT) controls over correspondent banking activities and private banking business; 15 on Als' controls for protecting customer data; 22 on Als' retail wealth management activities, focusing on the selling of insurance and structured products; and 10 to review Als' investment advisory activities under co-ordinated efforts with the Securities and Futures Commission (SFC).

¹ Institutions authorized under the Banking Ordinance to carry on banking business or the business of taking deposits. Authorized institutions are divided into three tiers: licensed banks, restricted licence banks and deposit-taking companies.

The HKMA conducted 86 risk-based and 10 overseas examinations, including reviews of selected Als' operations in Mainland China. Specialist teams carried out detailed examinations of risk management controls in specific areas, including nine examinations of Als' treasury and derivatives activities, seven tier-2² examinations of the securities business of Als, 15 reviews of selected Als' business continuity planning for a possible pandemic, and five examinations of Als' Internet banking activities and technology risk management practices. The HKMA also began tier-2 examinations of the effectiveness of selected Als' procedures to combat money laundering and terrorist financing.

In addition to on-site examinations, the HKMA conducted 185 off-site reviews and held 51 tripartite meetings, while resources were also devoted to other duties including the approval of acquisitions of local Als and handling non-compliance with guidelines or statutory requirements. Regular contact was made with the boards of directors of locally incorporated Als or important committees under the boards. The supervisory teams met the boards of six banks and members of board-level committees, in particular the audit committees, of 13 other banks and two restricted licence banks.

The Banking Supervision Review Committee considered 14 cases relating to the licensing of Als and money brokers and a case concerning an Al's possible breach of the Banking Ordinance. In addition, 278 applications to become controllers, directors, chief executives and alternate chief executives of Als were approved. Details of the operational supervisory work performed in 2006 are set out in Table 1.

Table 1. Operational Supervision

	2005	2006
1. On-site examinations	228	247
<i>Regular examinations</i>		
– risk-based	92	86
– overseas	11	10
<i>Specialised examinations</i>		
– treasury and derivatives activities	8	9
– securities (tier-2)	5	7
– e-banking activities and technology risk management	17	5
– AML/CFT controls (tier-2)	–	4
– business continuity plan	17	15³
<i>Thematic examinations</i>		
– renminbi banking business	18	25
– implementation of the standardized (credit risk) approach and the IRB approach under Basel II	–	17
– AML/CFT controls over correspondent banking and private banking	–	22
– controls for protecting customer data	–	15
– retail wealth management	14	22
– investment advisory activities	–	10
– trade financing	22	–
– residential mortgage	24	–
2. Off-site reviews and prudential interviews	187	185
3. Tripartite meetings	71	51
4. Meetings with boards of directors or board-level committees of Als	18	21
5. Approval of applications to become controllers, directors, chief executives, alternate chief executives of Als	332	278
6. Reports commissioned under Section 59(2) of the Banking Ordinance	4	1
7. Cases considered by the Banking Supervision Review Committee	7	15

² **Tier-1 examinations** are high-level examinations which assess and evaluate the adequacy of Als' general management controls over the areas being examined. **Tier-2 examinations** are more detailed and focused assessments of the effectiveness of the Als' relevant controls, including detailed testing and verification.

³ In 2006, the examinations focused on assessing Als' preparedness for a possible pandemic.

The HKMA used its powers under Section 59(2) of the Banking Ordinance to require one AI to commission external auditors to review its treasury and derivatives business and report their findings to the HKMA. Seven AIs voluntarily appointed external auditors to review their controls on selected areas identified by the HKMA as cause for concern. Improvements were subsequently implemented.

No AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio, the liquidity ratio, large exposures under Section 81 and connected lending under Section 83 of the Ordinance. However, there were two technical breaches of the requirements for the holding and acquisition of share capital of companies under Section 87 and Section 87A. These breaches, which were determined to be unintentional, were promptly rectified and did not affect the interests of depositors.

CAMEL⁴ rating review

The CAMEL Approval Committee met nine times during the year to determine the CAMEL ratings of individual AIs. The AIs were notified of the ratings and were given the opportunity to request a review of their ratings, although none did so. These ratings of licensed banks were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board before the end of the year to help it determine the contributions to be paid by the banks in 2007 under the Deposit Protection Scheme.

Appointment of Manager

The appointment of a Manager, on 16 September 2005, under section 52(1) of the Banking Ordinance to manage the affairs, business and property of Delta Asia Credit Limited (DAC), a deposit-taking company, continued during 2006. The HKMA continued to communicate with the relevant overseas authorities to monitor developments related to DAC and its parent bank in

Macao, and review regularly the supervisory measures to safeguard the interests of DAC's depositors and the integrity of the banking system.

Prevention of money laundering and terrorist financing

One of the major supervisory focuses of the HKMA in 2006 was to further strengthen the oversight of AIs' controls for combating money laundering and terrorist financing, and to ensure the supervisory framework's compliance with international standards. A specialist team was established through the internal redeployment of resources to conduct tier-2 examinations of AIs and thematic examinations on selected high-risk areas. To help prioritise the HKMA's supervisory efforts, the specialist team implemented a risk-profiling process for assessing the inherent money laundering and terrorist financing risks and the effectiveness of the risk mitigation processes adopted by AIs.

With the results of the risk-profiling exercise, the team conducted four tier-2 and 22 thematic examinations covering various risk areas including AIs' controls over correspondent banking and private banking businesses. The HKMA identified and shared with the industry improvements recommended for the oversight of transaction-based intermediary businesses. In addition, 55 high-level (tier-1) examinations were conducted as part of the risk-based examinations of individual AIs in 2006.

In March, the HKMA issued a report to the banking industry summarising the results of an industry-wide self-assessment on compliance with the regulations. The results, while suggesting a high level of compliance, also reflected some issues and challenges faced by the industry. As a result, the HKMA co-ordinated the establishment of an Industry Working Group and three User Sub-groups in June to further improve the banking industry's ability to guard against improper activities, and to promote industry standards and best practices. The Working Group chaired by the HKMA meets quarterly.

⁴ An internationally recognised framework for assessing the quality of banks based on **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity.

In October, a circular was issued setting out the HKMA's approach to formalise the use of supervisory measures for addressing serious money-laundering or terrorist-financing concerns identified in individual AIs. This approach aims to provide a more structured framework for the HKMA to differentiate the seriousness of AIs' deficiencies, determine the supervisory measures to be taken, and encourage AIs to quickly address concerns.

The HKMA revised the AML guidelines on wire transfers in November to implement *Special Recommendation VII* issued by the Financial Action Task Force (FATF) on Money Laundering. Under the revised requirements, an ordering AI must include some additional basic information about the originating customer in the message of a cross-border remittance transaction of \$8,000 or more, with effect from 2 January 2007. To align with amendments to the Organised and Serious Crimes Ordinance, a circular was also issued in December requiring AIs to lower the threshold for customer identification and record-keeping requirements from \$20,000 to \$8,000 for remittance or money-changing transactions executed for non-account holders.

The HKMA consulted the industry in April on whether Hong Kong should adopt a threshold-based transaction reporting system (reporting to a central agency by banks and other financial institutions and intermediaries of all transactions in any currency above a fixed amount) pursuant to *FATF Recommendation 19*. The consultation helped the Government assess the proposal. The industry was not attracted to the idea because of the significant costs associated with developing and operating the system and the fact that it would not help AIs detect suspicious transactions. The industry comments were passed to the Government for consideration.

The Narcotics Division of the Security Bureau, the Joint Financial Intelligence Unit and the HKMA jointly held an anti-money-laundering seminar for the banking industry in September to brief the compliance officers of AIs on key issues relating to customer due diligence and suspicious transaction reporting. Two briefing sessions were conducted for the chief executives of AIs on 27 September, providing them with an update on major anti-money-laundering issues and challenges affecting the industry and the role they are expected to play in combating money laundering and terrorist financing.

China-related businesses

Renminbi banking business

At the end of 2006, 39 licensed banks were eligible to conduct renminbi business while the total amount of renminbi deposits reached RMB23.4 billion yuan. From March 2006, Participating Banks are allowed to open current accounts for Hong Kong residents to use renminbi cheques to pay for personal consumption in Guangdong Province (including Shenzhen). To facilitate the cross-border clearing and settlement of renminbi cheques, the Clearing Bank for renminbi banking business co-operated with Hong Kong Interbank Clearing Limited to establish a new Renminbi Settlement System in the first quarter of 2006, which was subsequently upgraded for the settlement of other renminbi transactions.

The HKMA continued to monitor the renminbi business. To cope with the expanded services, the HKMA revised the related prudential returns in the first quarter of 2006. Results of thematic examinations covering 25 AIs offering renminbi banking services indicated that their internal control systems were sufficient to ensure compliance with the applicable business restrictions and detect irregular transactions. There was scope for some AIs to improve their controls and the HKMA issued a circular to share with the industry the common issues and good practices identified during the examinations.

Non-bank China exposures

The HKMA has required Als to report their exposures to specified non-bank Mainland entities since December 1998. With the increasing economic integration between Hong Kong and the Mainland, the HKMA revised its reporting framework in December 2005 to include exposures arising from credit facilities granted by Als to non-Chinese entities but for use on the Mainland. Reporting of the new data series commenced with the September 2006 position. At the end of 2006, the industry's aggregate on-balance sheet non-bank China exposures amounted to HK\$430.5 billion, or 4.7% of all Als' total assets.

Mainland's relaxation of controls over foreign investments

Mainland authorities announced a series of rules and notices in the second quarter of 2006 allowing commercial banks, fund management and securities companies, and insurance companies to provide wealth management services for Mainland individuals and entities to invest outside Mainland China. Among these institutions, commercial banks operating on the Mainland, including foreign banks' Mainland operations, are allowed to start the new business after obtaining approval from the China Banking Regulatory Commission (CBRC) and the foreign exchange quota from the State Administration of Foreign Exchange (SAFE). At the end of 2006, four banks incorporated in Hong Kong had been given approval by the CBRC to conduct the new business. To ensure the scheme is properly implemented, the CBRC, SAFE, the HKMA and the SFC have formed a joint working group to improve cross-border supervisory co-operation.

Mainland banking market opens up

Monday 11 December 2006 marked the opening up of the Mainland banking market under the Regulations on the

Administration of Foreign-funded Banks, which were announced by the State Council in November, honouring the commitment given by China on accession to the World Trade Organization. The CBRC also subsequently announced the Implementation Rules to supplement the new regulations.

Under the Regulations, foreign-funded banks incorporated on the Mainland are entitled to "national treatment", which allows them to conduct banking business on a level playing field with domestic banks. This includes full-scope renminbi banking business targeting all customers (including Mainland residents) in Mainland China, provided they fulfil the prudential requirements equally applicable to domestic banks. Foreign banks operating branches on the Mainland are allowed to take renminbi time deposits from Mainland residents of not less than RMB1 million yuan.

The HKMA has maintained close contact with individual banks to understand their business strategy in Mainland China in light of the new framework. There is also regular dialogue with the CBRC to improve cross-border supervisory co-operation and co-ordination for the expected increasing presence of Hong Kong banks on the Mainland. At the end of 2006, the CBRC had approved three Hong Kong-incorporated banks to restructure their existing Mainland branches to Mainland-incorporated banking subsidiaries.

CEPA

Since the implementation of the Closer Economic Partnership Arrangement in 2004, Hong Kong banks have gained greater access to the Mainland market. At the end of 2006, 8 banks were entitled to establish a Mainland presence under CEPA. Of these, 5 had opened a total of 8 branches. In response to the opening up of the banking market in December, CEPA may be further refined to improve the competitive edge of Hong Kong banks on the Mainland.

Residential mortgage loans

Competition among Als for residential mortgage business intensified in 2006. This prompted the HKMA to closely monitor how well Als were managing the risks, particularly whether they were taking on excessive risks (especially interest rate risk) that they were not in a position to manage, and whether Als had adopted prudent risk management and complied with the prudential guidelines. The results of the assessment did not indicate, at this stage, any serious supervisory concerns. Nevertheless, the HKMA reminded individual Als of the need to be alert to the management of interest rate risk since the flexibility for Als to raise their prime rates could, at times, be limited by market competition. During its regular on-site examinations, the HKMA also reviewed the residential mortgage business of 20 Als, which showed they continued to adopt prudent underwriting criteria and practices.

Treasury activities

In addition to its specialised on-site examinations of Als' treasury operations, the HKMA conducted a benchmarking review on the stress-testing practices of selected Als on market and interest rate risks associated with treasury activities. This follows the growing involvement of the banking sector in dealing with complex structured products and the uncertainties surrounding interest rate movements, which have increased the risks faced by Als' treasury operations. After the review, the HKMA issued a circular to all Als in November to highlight the good industry practices identified in the exercise.

Co-operation with overseas supervisors

The HKMA continued to maintain a close working relationship with overseas regulators, signing Memoranda of Understanding with the Financial Supervisory Commission of Korea, the Swiss Federal Banking Commission and the South African Reserve Bank during the year to provide a formal framework for supervisory co-operation and the sharing of information. The establishment of similar arrangements was discussed with a number of other overseas supervisory authorities. Meetings to discuss supervisory issues of common interest were also held in Hong Kong and overseas with banking supervisors from the Mainland, Macau, Taiwan, the US, the UK, Australia, France, Germany, India, Indonesia, Italy, Japan, Pakistan, the Philippines, South Korea, Switzerland, Thailand and Vietnam.



Mr Yoon Jeung-Hyun (left), Chairman of the Financial Supervisory Commission of Korea, and Joseph Yam, Chief Executive of the HKMA, sign the Memorandum of Understanding.

Supervision of technology and operational risks

Internet banking and technology risk management

The HKMA has established a supervisory framework to promote a safe and sound environment for Internet banking, which continued to grow during the year. By the end of 2006, Hong Kong had some 3.8 million personal Internet banking accounts, 15% higher than a year earlier; and 234,000 business or corporate Internet banking accounts, up 44%. In May 2005, Hong Kong launched two-factor authentication for high-risk transactions conducted through Internet banking, becoming one of the first jurisdictions among developed financial markets to mandate the system. Since its launch, 30 AIs have implemented the additional safeguards and around 1.4 million customers (up 49%) have registered for the service.

The HKMA extended the coverage of the automated control self-assessment process for Internet banking and technology risk management to 60 AIs. The results of the self-assessments indicated a marked improvement in the overall IT control of AIs since the process began in 2003.

Following a leak of credit card data in the US in 2005, the HKMA requested all AIs to perform a detailed self-assessment of their security controls over customer data. To ensure there were adequate controls to protect customer data and the issues identified in the self-

assessment had been satisfactorily addressed, the HKMA reviewed the controls of 15 AIs. The overall level of control was found to be acceptable. However, improvements were needed in safeguarding sensitive customer data stored in peripheral devices, such as notebook computers and memory devices, and on hard-copy documents, or data processed and maintained by outside service providers. A circular was issued to all AIs on the common issues identified.

Business continuity management

Since November 2005, the HKMA has worked with the banking industry to ensure a high degree of preparedness for a possible pandemic and to minimise any systemic risk. An industry task force involving eight major banks was established by the HKMA to monitor avian flu developments and to review applicable good business continuity planning practices for the banking sector. An article published in the June 2006 *HKMA Quarterly Bulletin* included a discussion of the possible supervisory response and regulatory forbearance to be considered by the HKMA in the event of a pandemic. The HKMA also carried out specialised examinations of 15 AIs' business continuity plans, which showed they had largely completed their preparation, verification and testing by mid-2006, and had drawn on their experience and lessons learned during the 2003 SARS outbreak and preparations for the World Trade Organization's Sixth Ministerial Conference in December 2005.

Supervision of ancillary activities

Securities and insurance businesses

The HKMA and the SFC liaise closely on matters of common supervisory interest, and two meetings were held in 2006 to discuss the supervision of securities business of Registered Institutions (RIs). Under the transitional arrangements of the Securities and Futures Ordinance, the HKMA has been working with the SFC to

process migration applications of AIs with deemed "Registered Institutions" status to become RIs. At the end of 2006, 74 deemed RIs had lodged their migration applications. Of these, three revoked their status as AIs (and thus their deemed RI status). The HKMA had assessed most of the applications, resulting in 64 deemed RIs being registered with the SFC. It also granted consents to 86 executive officers, who are responsible for supervising the securities activities of RIs.

To gradually extend the coverage of self-assessment compliance, the HKMA increased the number of participating RIs by 10, to 40, in 2006. A circular was issued in September to highlight important regulatory requirements and recommend sound practices concerning the self assessment system to ensure the fitness and propriety of staff engaged in securities activities and other related duties.

The results of joint HKMA and SFC thematic examinations on securities business during the year indicated that the product due diligence process was acceptable and the controls were generally in place. Thematic examinations on the retail wealth management business of AIs and their compliance with codes and guidelines on the sale of investment-linked insurance and structured products to retail customers showed the banks' procedures were effective. However, some AIs were required to further improve their client and product suitability procedures.

Securities enforcement

Procedural improvements were completed and, together with the expansion of the Securities Enforcement Team, these led to notable benefits in the efficiency and effectiveness of investigations and disciplinary reviews. In the final quarter of 2006, a Securities Enforcement Division was established to handle enforcement issues and related complaints.

Investigation of 17 cases opened previously continued in 2006. Another 12 cases were opened for investigation by the Event Review Committee, which is responsible for deciding whether to open cases for disciplinary investigation. At the end of 2006, the investigation of 19 cases was in progress.

The Disciplinary Committee, which makes recommendations on the exercise of disciplinary powers, considered three cases following the completion of the investigation and disciplinary review.

The HKMA and the SFC jointly disciplined three existing and former "relevant individuals" of a Registered Institution for unlicensed dealing and supervision failure. This was the first time for the two regulators to take joint disciplinary action under the Securities and Futures Ordinance.

The investigation into another case of suspected unlicensed dealing by an authorized institution was completed and referred to the SFC to consider prosecution and further investigation. A suspected breach of the Banking Ordinance uncovered in the case was referred to, and followed up by, the Banking Supervision Department. The Disciplinary Committee also reviewed a case involving the acceptance of pre-signed blank Investment Funds Dealing Order Forms from a client. The Monetary Authority, on the advice of the Committee, decided to impose disciplinary sanctions on the current "relevant individual" and recommend the SFC take disciplinary action against the former "relevant individual".

Investigations into another seven cases found there were insufficient grounds for disciplinary action. These cases included suspected misrepresentation and other improper acts in soliciting investment funds and securities, suspected failure to provide adequate fund-switching advice and suspected failure to exercise due diligence when acting as a sponsor.

Banking sector infrastructure

The Deposit Protection Scheme was launched on 25 September 2006, and good progress was made in expanding the coverage of the Commercial Credit Reference Agency to include sole proprietorships and partnerships.

Deposit Protection Scheme

Final preparations for the launch of the Scheme were completed by the Hong Kong Deposit Protection Board, with the assistance of the HKMA. These included formulation of all rules and guidelines governing the Scheme's operation, the amendment of Schedule 1 to the Deposit Protection Scheme Ordinance to clarify the treatment of structured products, and the development of a payout system and procedures for promptly compensating depositors. Starting from 25 September, eligible depositors are entitled to compensation of up to \$100,000 in the event of a bank failure. The Board also launched an extensive publicity programme on the key features of the Scheme.

Commercial Credit Reference Agency

The CCRA has been operating smoothly since its establishment in November 2004. It covers more than 48,000 small and medium-sized enterprises defined as non-listed companies with an annual turnover not exceeding \$50 million. More than 120 AIs are sharing commercial credit data through the CCRA.



Executive Director (Banking Development), also Chief Executive Officer of the Hong Kong Deposit Protection Board, Raymond Li (left) and Chairman of the Board Professor Andrew Chan at a press conference to announce the launch of the Scheme.

The HKMA participated in the Industry Working Group on the CCRA. During the year the Group devised the implementation details for expanding the coverage of the CCRA to include sole proprietorships and partnerships.

Consumer credit data sharing

The HKMA completed the second review of the benefits of positive consumer credit data sharing, based on a set of indicators agreed with the Consumer Council. The review reaffirmed that benefits were being shared between consumers and financial institutions. With improved access to positive data after the moratorium, financial institutions are capable of offering more personalised interest rates to their customers taking into account the credit ratings assigned by the credit reference agency. Consumers benefit by maintaining a good credit record.

Consumer protection

Code of Banking Practice

The banking industry completed the annual self-assessment of compliance with the Code of Banking Practice covering the period from June 2005 to May 2006. One hundred and seventy-two AIs providing personal banking services conducted the self-assessment. One hundred and fifty AIs reported full compliance with the Code, 19 identified five or fewer instances of non-compliance and three identified more than five. The main areas of non-compliance related to the advance of loans and overdrafts, and terms and conditions of banking services. Most AIs reported they had adequate systems of control and management oversight to ensure compliance with the Code. As soon as AIs identified non-compliance, the HKMA required them to take prompt remedial action.

 > [Consumer Information](#) > [Code of Banking Practice](#)

Customer complaints

The HKMA received 292 customer complaints about banking services provided by Als, compared with 328 the previous year (Chart 1). The decline was noted across all types of banking services, including the number of complaints against debt collection agencies (DCAs) appointed by Als. The quarterly returns submitted by Als since March 2002 show the number of DCA-related complaints further decreased to 129 in 2006 from 171 in 2005, indicating that Als have been vigilant in monitoring the performance of their DCAs (Chart 2).

 > Consumer Information > Complaints about Banks

Consolidation of bank branches

Increased competition in the banking sector, together with the introduction of new technology, has led some

banks to consolidate their branches. At the request of the HKMA, the Hong Kong Association of Banks established a special task force in January 2006 to identify ways to minimise the impact of branch closures on the public. In June, after detailed discussions, the Task Force announced, and has begun implementing, a series of recommendations. These include simplifying the operating procedures of ATMs to facilitate their use by senior citizens, developing community-wide education programmes on the use of ATMs, encouraging banks to give priority to setting up ATMs or self-service banking centres in public housing estates where the establishment of a bank branch is not feasible, and exploring with EPS the feasibility of cash withdrawals independent of any purchase of goods at selected retailers.

Chart 1. Complaints on banking services of Als received by the HKMA

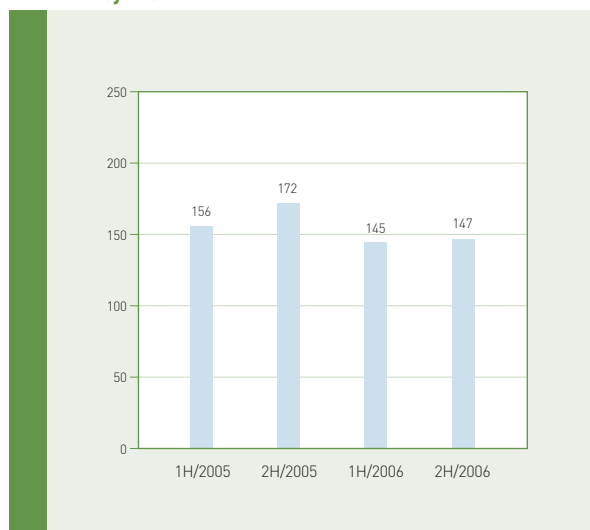


Chart 2. DCA complaints received by Als



Basel II Implementation

The HKMA, together with the banking industry and the Government, completed the preparatory work for the implementation of Basel II in Hong Kong on 1 January 2007. The HKMA also continued to provide assistance to the industry in their preparation for compliance with the requirements under the new capital adequacy framework.

Legislation

Banking (Capital) Rules and Banking (Disclosure) Rules

Following extensive consultation on earlier implementation proposals on the new capital requirements and disclosure standards under Basel II, rules were developed during the year for implementing the minimum capital requirements (Pillar 1) and market discipline requirements (Pillar 3). The Banking (Capital) Rules and the Banking (Disclosure) Rules under the Banking Ordinance came into effect on 1 January 2007. They prescribe how the capital adequacy ratio (CAR) of Hong Kong-incorporated Als is to be calculated and what information on the state of affairs, profit and loss, and CAR is to be publicly disclosed by Als. The Rules were made following consultation with the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, the DTC Association and the Financial Secretary as required under the Banking Ordinance, as well as a wide range of stakeholders in the community.

Appeal mechanism

The Capital Adequacy Review Tribunal was established by the Government, as required under the Ordinance, with the appointment of a chairman and four members for a three-year term also with effect from 1 January 2007. This independent body will review, on application of an aggrieved institution, decisions made by the Monetary

Authority under the Banking (Capital) Rules on the choice of approaches for the calculation of credit, market and operational risks.

Pillar 1

New CAR returns and parallel reporting

A new CAR return was developed for Als to report their CAR calculations under the new framework, starting from their positions at the end of March 2007. An exercise requiring Als to report their CARs based on both the previous CAR return and the new return was conducted for the positions at the end of September and December 2006. The aim of this “parallel reporting” was to familiarise Als with the reporting requirements, and to facilitate their compliance and impact assessment. Data submitted for the two reporting positions in 2006 indicated the overall impact on the capital adequacy ratio of the banking sector was as expected — the average CAR of Hong Kong-incorporated Als recorded a slight drop mainly because of the additional operational risk capital charge.

Recognition of ratings assigned by external credit assessment institutions

The new framework allows the use of credit ratings assigned by recognised external credit assessment institutions (ECAIs) for determining risk-weights of credit exposures. These include the standardized (credit risk) approach for general credit exposures and the standardized (securitisation) approach for securitisation exposures. The HKMA issued a policy paper setting out its approach to recognising ECAIs for Basel II in June 2006 and subsequently announced the recognition of ratings assigned by Standard & Poor's Ratings Services, Moody's Investors Service, Fitch Ratings, and Rating and Investment Information, Inc.

Revised market risk framework

The HKMA incorporated into the Banking (Capital) Rules the existing capital framework for market risk together with new standards laid down by the Basel Committee on Banking Supervision (Basel Committee) for trading book definition, prudent valuation, alignment of capital treatment for exposures held in the trading book and the banking book, and specific risk modelling. The Rules are supplemented by a supervisory policy manual (SPM) module on *Use of Internal Models Approach to Calculate Market Risk*. This technical note incorporated additional guidance on the minimum requirements for using the internal-models approach and replaced the previous technical note on *Use of Internal Models to Measure Market Risk*.

Assessment of Als' readiness for Basel II

Preparations for the adoption of the IRB approaches by Als continued to make good progress in 2006 and placed Hong Kong at the forefront of jurisdictions offering the advanced approaches under Basel II.

At the start of 2006, the HKMA finalised the guidance note on the validation of risk rating systems under the IRB approach after incorporating industry comments on the draft issued in 2005. The guidance note sets out the HKMA approach to the validation of Als' internal rating systems and the requirements the HKMA expects Als to meet in order to use the IRB approach. It was issued as an SPM module in February 2006.

Regulatory approaches to IRB validation continue to evolve rapidly and, following clarification of the use test by a number of leading regulatory agencies, the HKMA revised its own requirements on the use test in the second half of 2006. The changes were made to ensure the HKMA's requirements are consistent with those of jurisdictions with which it has close home/host co-operation, and to ensure a level playing field among the IRB applicant Als in Hong Kong, which are predominantly subsidiaries of foreign banking groups. The changes were set out in a feature article in the December 2006 issue of the *HKMA Quarterly Bulletin*.

As individual Als planning to adopt the IRB approach between 2007 and 2009 moved closer to their target implementation dates, the HKMA engaged them in more frequent dialogue in 2006 to monitor their progress, develop a more detailed understanding of their rating systems, and provide guidance on emerging implementation issues at the Als' request.

The HKMA has undertaken assessments including on-site examinations of Als planning to adopt the foundation IRB approach in 2007. The on-site examinations of several Als intending to adopt the IRB approach in 2008 have also begun.

In relation to the implementation of the standardized (credit risk) approach, the HKMA conducted a number of high-level examinations focusing on the board and senior management oversight and overall project management of 14 Als. The results indicated that Als generally had adequate oversight of the Basel II implementation efforts.

Home/host co-operation

As the majority of Hong Kong-incorporated Als planning to adopt the IRB approach are subsidiaries of foreign banking groups, the HKMA, as host supervisor, intensified its communication with the home supervisors of these banking groups. The aim was to keep home and host authorities updated on the IRB implementation progress of individual banking groups, discuss issues of mutual concern including the allocation of responsibilities for IRB system validation, avoid supervisory overlap, and reduce the regulatory burden on the banks.

Pillar 2 framework

The HKMA has developed a detailed and rigorous assessment framework based on its existing risk-based supervisory system to help conduct the supervisory review process recommended under Pillar 2. This framework, which takes into account an AI's overall risk profile and management systems, the extent of its exposure to risks not covered under Pillar 1, and its approach to conducting internal capital assessments, will be used by the Monetary Authority to evaluate and monitor the capital adequacy of individual Als, and to determine their minimum CAR under the Banking Ordinance. The assessments will also help the Monetary

Authority to set the supervisory priorities for individual Als and facilitate an industry-wide analysis of banking risks. Details of the framework, including the procedures for ensuring the quality, objectivity and consistency of the assessments, were, after industry consultation, set out in an SPM module *Supervisory Review Process* issued as a statutory guideline in November 2006.

Pillar 3 requirements

The Banking (Disclosure) Rules apply to Als' first financial year commencing on or after 1 January 2007. For Als whose financial year commences on 1 January, their first disclosures under the new regime will be the interim disclosures relating to 30 June 2007. However, the Rules will not apply to a minority of Als with a financial year commencing on a date other than 1 January until their 2006/2007 financial years end. For Als in this category, the HKMA has provided guidance on the disclosure requirements during the transition period until the start of their 2007/2008 financial years. These institutions are required to continue to apply the appropriate SPM modules on financial disclosures and follow the changes in certain disclosure items as a result of the replacement of the Third Schedule to the Banking Ordinance by the Banking (Capital) Rules.

 > Basel II

Developing supervisory policies

Credit card business

In January 2006, the HKMA issued an SPM module on *Credit Card Business* to provide AIs with guidance on the management of risks associated with credit card business. The module also advocates the development of risk-based pricing using information obtained from external credit reference agencies and taking a constructive view of restructuring and debt relief plans to help cardholders with repayment problems.

Use of fair value option for financial instruments

Section 40(2) of the Banking (Capital) Rules provides that an AI may, with the prior consent of the MA, include fair value gains arising from its holdings of equities and debt securities designated at fair value through profit or loss in its core capital to determine capital base. The consent is conditional on the MA being satisfied that the AI's controls over the use of the fair value option (FVO) meet certain minimum prudential standards. An SPM module on *Use of the Fair Value Option for Financial Instruments* was issued by the HKMA on 7 November 2006 to set out the minimum risk management and control standards an AI should meet in its use of the FVO. The guideline also provides information on how the HKMA will assess an AI's risk management and controls in using the FVO.

New share subscription and share margin financing

An SPM module on new share subscription and share-margin financing was issued as a statutory guideline in January 2007. This sets out the minimum business and control standards expected of AIs financing their clients' subscription for new share issues, acting as a receiving bank in an initial public offering (IPO), or providing share-margin financing to clients (including stockbrokers). The module also analyses the risks associated with these

activities, draws AIs' attention to the security measures they should observe in handling IPO refund monies, and specifies precautions AIs should take to mitigate the risk of unauthorised pledging of shares related to their lending to stockbrokers.

International co-operation

The HKMA participates in various regional and international forums for bank supervisors, including the Basel Committee's International Liaison Group, the EMEAP Working Group on Banking Supervision, the Offshore Group of Banking Supervisors and the South East Asia, New Zealand and Australia Forum of Banking Supervisors. The HKMA chairs the EMEAP Working Group on Banking Supervision, which meets twice a year to promote information sharing and regional co-operation on banking supervision.

In December, the Working Group and the Financial Stability Institute jointly organised a high-level meeting on the implementation of Basel II and other regional supervisory priorities. The two-day meeting enabled banks and bank regulators to exchange knowledge and concerns in promoting the common goal of prudent risk measurement and management under Basel II. Hosted by the HKMA, the meeting attracted 70 representatives from 23 central banks and supervisory authorities and 21 leading commercial banks. Distinguished speakers included Mr Nout Wellink, Chairman of the Basel Committee and Mr Josef Tosovsky, Chairman of the Financial Stability Institute, and senior executives from major international banks in the region.

As a member of the Basel Committee Accord Implementation Group's Validation Sub-group, the HKMA participated in the quarterly meetings to expedite the exchange of views on IRB system-related validation issues with other leading regulators. The HKMA also shared its experience in implementing specific areas of Basel II with regional supervisors at technical workshops or briefing sessions.

The HKMA hosted the Conference for International Supervisors on Information Technology in April 2006, for banking supervisors from 15 major financial markets to share their experiences in the supervision of Internet banking and technology risk management.

The HKMA and the International Monetary Fund jointly hosted a regional conference in Hong Kong in July to share experiences in helping other markets in the Asia Pacific region to prepare for a possible pandemic. The framework for effective cross-border communications with banking supervisors of major financial markets in emergencies continued to improve.

Accounting and disclosure

Impact of new standards on capital requirements and regulatory reporting

Since January 2005, Hong Kong-incorporated AIs have been required to prepare financial statements according to new Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards. These are broadly equivalent to the International Financial Reporting Standards.

To assess their overall impact on the banking system, the HKMA conducted a study of AIs' first full-year financial results. This covered 16 licensed banks, representing about 97% of the total assets less provisions, or 98% of the total customer deposits, of all Hong Kong-incorporated AIs.

The study showed that the increased use of fair values in the preparation of financial accounts under the new Standards is likely to lead to greater volatility in the banks' reported earnings. While the overall effect was slightly positive on the banks' reported profit (+2.9%), the impact varied considerably from bank to bank, ranging from +29% to -9%. The primary impact on the banks' balance sheets was an overall reduction in accounting equity both at transition and at the end of the 2005 financial year (-5%). This was mainly due to the

reclassification of preference shares from equity to liabilities in accordance with *HKAS 32, Financial Instruments: Disclosure and Presentation*. *HKAS 17, Leases* had a larger effect than anticipated. It not only had an adverse impact on banks' equity, but also reduced certain banks' CAR modestly by 0.1 to 1.4 percentage points. The study confirmed the HKMA's policy of requiring AIs to maintain a regulatory reserve, in addition to their accounting provisions, was useful in maintaining the overall level of provisions in the banking system at a broadly similar level to that before the implementation of the new Standards.

The study also identified two issues that require further improvement: the adequacy of the models used by AIs for the determination of provisioning levels; and the method for setting an appropriate level of regulatory reserve.

The HKMA will continue to keep abreast of accounting and disclosure developments, particularly in the implementation of the Banking (Disclosure) Rules and *HKFRS 7, Financial Instruments: Disclosure*.

PLANS FOR 2007 AND BEYOND

Risk-based supervision

A review of the further development of the risk-based supervisory approach, started in 2006, will continue. The preliminary conclusion is that the supervisory process will benefit from further specialisation, focusing on selected risks and business areas of the banking sector to ensure the approach remains effective given the growing complexity in banking operations and the regulatory environment. The HKMA will complete the review in 2007 and implement the recommendations as appropriate. The HKMA will fine-tune its CAMEL rating assessment of AIs to harmonise the system with the supervisory review process under Pillar 2 of Basel II. The revised CAMEL rating system will provide a more detailed assessment of the risk of individual AIs.

Lending businesses

Through on-site examinations and off-site surveillance, the HKMA will continue to monitor Als' management of the risks related to their lending businesses. Focus will be placed on whether there is an observable relaxation in underwriting criteria among Als amid the intense competition in the banking industry. In particular, the HKMA will monitor closely Als' residential mortgage loans and personal lending businesses, and assess their compliance with the prudential guidelines and their ability to manage the interest rate risk. The HKMA will also review individual Als' share financing and related businesses and their ability to withstand the impact of any significant market fluctuation, in view of the significant volatility in the stock market during the latter half of 2006.

China-related businesses

Renminbi banking business

On 10 January 2007, the State Council announced a further expansion of renminbi business in Hong Kong by allowing qualified Mainland financial institutions to issue debt securities in Hong Kong. The HKMA is considering the relevant supervisory requirements for this development, and new supervisory circulars and revised prudential returns will be issued where necessary. Thematic examinations will also be conducted on the expanded scope of renminbi banking services.

Als' operations on the Mainland

With the growing importance of Mainland business to Hong Kong-incorporated Als, and the plans of some of them to turn their Mainland operations into Mainland-incorporated banking subsidiaries, the HKMA will closely monitor Als' Mainland operations in 2007. In addition to conducting on-site examinations under the MoU between the HKMA and the CBRC, the HKMA will assess the adequacy of Als' oversight of their Mainland operations during off-site reviews and regular risk-based examinations. Thematic examinations will also look at the investment and related services provided by Als under the scheme for relaxed foreign investments by Mainland residents.

Supervision of technology and operational risks

Internet banking, technology risk management and business continuity management

With the growing acceptance of Internet banking services and Als' increasing dependence on technology, the HKMA will conduct more thematic examinations on related subjects. These will include IT systems and infrastructure management, and systems support for Basel II implementation. Als will be asked to perform supervisory control self-assessments on Internet banking, technology risk management and business continuity planning. The HKMA will maintain close contact with the banking industry and the Police to promote sound control practices and awareness of emerging fraud techniques, and to develop effective customer education programmes.

The HKMA will participate in the International IT Supervisors Group, which comprises 20 banking supervisors from developed markets, to discuss issues of common concern.

Operational risk management

As a result of the increasing importance of Als' operational risk management, the HKMA will establish a specialist team for supervising this risk area. The team will be responsible for implementing a supervisory framework and developing a system for assessing individual Als' operational risk profiles. Thematic examinations of selected high-risk areas in operational risk management will also be conducted in 2007.

Securities and insurance businesses

The HKMA will continue to co-operate with the SFC and the Insurance Authority on the supervision of Als' securities and insurance-related businesses. This includes working with the SFC on the review of regulatory standards for the selling of investment products to retail customers and the implementation of the new regime on IPO sponsors. Thematic examinations

of RIs' controls for ensuring the fitness and propriety of staff involved in the securities business will be conducted in 2007. There will also be follow-up examinations on the implementation of the recommendations arising from previous examinations on retail wealth management business.

Steps will be taken to further streamline communications between the HKMA and the SFC under the MoU between them. The reciprocal secondment programme between their enforcement functions will continue to improve staff training and to ensure better understanding of each other's practices to promote consistency in enforcement.

Developing banking sector infrastructure

The HKMA will assist the Hong Kong Deposit Protection Board in maintaining an effective Deposit Protection Scheme, and support the industry in further developing the Commercial Credit Reference Agency.

Deposit Protection Scheme

In the first year of the Scheme's operation, the Hong Kong Deposit Protection Board will focus on consolidating and improving the various newly established systems and monitoring the effectiveness of the systems. Simulations and payout rehearsals will be conducted. Increasing public awareness and understanding of the Scheme will also be a focus of the work in 2007.

Commercial Credit Reference Agency

The HKMA will collaborate with the CCRA Industry Working Group to complete the remaining preparatory tasks for the inclusion of sole proprietorships and partnerships in the Agency.

Consumer protection

Promoting industry self-regulation and improving the standards of banking practices through participation in the Code of Banking Practice Committee will be maintained during the year. The HKMA will also monitor Als' compliance with the Code through the self-assessments and handling of complaints about banking services.

Basel II implementation

Monitoring and assessment of impact

The commencement of the Banking (Capital) Rules and Banking (Disclosure) Rules on 1 January 2007 for the implementation of Basel II did not end the HKMA's role in this project. Work on the new framework will continue on a number of fronts throughout 2007 and beyond to improve the risk management practices of banks, including the development of supervisory guidance on the application of the Rules and updating relevant SPM modules to align with the Basel II requirements. The HKMA will continue to monitor the impact of the new framework on Als' capital adequacy ratios through the development of detailed internal management reports for analysing data reported under the new CAR return.

Supplementary guidelines

To assist Als in complying with the Rules, the HKMA will issue supplementary guidance, particularly on how some of the major requirements should be interpreted or applied. The guidance will also contain answers to some frequently asked questions arising from the consultation and rule-making processes. The HKMA released a draft guideline on the application of the Banking (Disclosure) Rules for industry consultation in the first quarter of 2007 to ensure that Als have sufficient time to prepare for the first set of disclosures under the Banking (Disclosure) Rules.

Pillar 2 implementation

Starting from 1 January 2007, the HKMA will conduct supervisory reviews on individual Als as part of the risk-based supervisory process. The scope and extent of applying the assessment standards and criteria set out in the SPM module on *Supervisory Review Process* will be compatible with the nature, size and complexity of Als' business operations. The results of the supervisory reviews will be used to assess the appropriateness of the minimum CAR and other supervisory priorities for individual Als. In addition, the HKMA will monitor Als' compliance with the capital adequacy and risk management standards set out in its supervisory guidelines. Where necessary, the HKMA will further refine its supervisory approach to focus on Als' high-risk areas, and continue to issue supervisory guidance on the risk management standards to help Als upgrade their existing systems and to meet the Basel II requirements.

IRB validation

The recognition process for Als intending to adopt the IRB approach will continue. Priority will be given to those Als planning to adopt the approaches in 2007/2008. As home/host co-operation intensifies for the international banking groups, the HKMA will continue to participate in supervisors' meetings and in model review visits organised by home supervisors.

More advanced approaches

In line with its plan for Basel II implementation, the HKMA will monitor international developments relating to the implementation of the more advanced approaches covering areas such as the measurement of operational risk and counterparty credit risk, and review the readiness of Als for adopting them.

Prevention of money laundering and terrorist financing

The HKMA restructured its policy and specialised examination teams in January 2007 to increase the effectiveness of its supervisory function, by centralising the teams under the same division responsible for overall co-ordination and monitoring of money laundering and terrorist financing activities. Additional resources and further training will be provided to the teams to enable more detailed and thematic examinations to be conducted in 2007.

Hong Kong's compliance with the latest FATF standards will be evaluated in the latter part of 2007 as part of the Task Force's third round of mutual evaluations on member jurisdictions. The HKMA will work with Government and the industry in preparing for the evaluations to ensure the banking sector complies, to the greatest extent possible, with the FATF standards.

Basel Core Principles

In October 2006, the Basel Committee on Banking Supervision issued the revised *Basel Core Principles for Effective Banking Supervision*. The revisions further clarify and strengthen areas in the *Core Principles* to address innovations and developments in banking, the financial instruments and markets within which banks operate, and the methods and approaches used by supervisors. The HKMA, which was involved in the initial drafting process, recognises the importance and relevance of the revised *Core Principles* as a flexible, up-to-date and globally applicable standard. In line with its policy of conforming with international supervisory best practices, the HKMA is planning to conduct a high-level review in 2007 to assess its compliance with the revised *Core Principles* and identify areas for further improvement.

Islamic finance

From relatively small beginnings 20 years ago, Islamic finance has grown into a market now estimated at US\$700 billion to US\$1 trillion. A number of financial centres outside the Middle East, such as London, Singapore and Malaysia, have encouraged the growth of Islamic finance business, and wholesale markets in Islamic financial products have been rapidly evolving. Although domestic demand for such products is likely to be modest, Hong Kong's position as an international financial centre creates an opportunity for it to develop wholesale markets in Shariah-compliant instruments as a complement to those in London and elsewhere in Asia. Hong Kong's legal system and regulatory structure is likely to be sufficiently flexible for the regulation of most Islamic capital products in the same way as other similar wholesale and retail financial products. The HKMA will work with the Government and other regulators to understand more about Islamic finance, and will develop policies to create the framework that would allow Islamic financial business to be transacted efficiently and to help maintain financial stability.

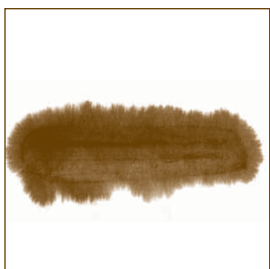
International co-operation

The HKMA will continue to participate in regional and international forums for bank supervisors to improve regional financial stability through compatibility with international regulatory and supervisory standards.

The Bank for International Settlements has invited 54 central banks and monetary authorities, including the HKMA, to participate in the triennial survey of activity in the foreign exchange and derivatives markets in 2007. Selected Als and some major securities houses will be invited to participate in the survey. Past surveys have been invaluable for both the public and private sectors in providing a snapshot of the size and composition of the foreign exchange and derivatives markets.

Development of supervisory policies

Key policies to be reviewed in 2007 include: the need for further guidance on setting a level of regulatory reserve for Als; and a supervisory guideline on how consolidated supervision of Als is practised by the HKMA and the laws, regulations, or prudential standards applicable to Als on a consolidated basis, covering areas such as capital adequacy, large exposures and lending limits.



Market Infrastructure

Hong Kong's advanced financial market infrastructure was further strengthened in 2006 following a comprehensive review in 2005. The Renminbi Settlement System and the link between Malaysia's ringgit RTGS system and Hong Kong's US dollar RTGS system were launched. The Exchange Fund Bills and Notes programme was reviewed to refine and make it more attractive to market makers. The Treasury Markets Association had a productive inaugural year with the launch of the Spot USD/HKD fixing and the Renminbi Non-deliverable Interest Rate Swap.

OBJECTIVES

One of the HKMA's policy objectives is to promote the development of a safe and efficient financial market infrastructure. This serves two inter-related purposes: helping to maintain financial and monetary stability and supporting Hong Kong's status as an international financial centre. Robust and effective clearing and settlement systems are important in nurturing the competitiveness of Hong Kong's financial sector. The HKMA pays particular attention to these systems for the safe and efficient transfer of funds and securities within Hong Kong and between Hong Kong and other financial centres, especially the Mainland. The comprehensive review of the financial infrastructure in 2005 paved the way for further developing Hong Kong into a regional payment and settlement hub.

processed a daily average value of \$579 billion in Hong Kong dollar CHATS transactions (around 18,000 items). On 27 October the system registered a record turnover of \$1.37 trillion because of large initial public offering (IPO) activities.

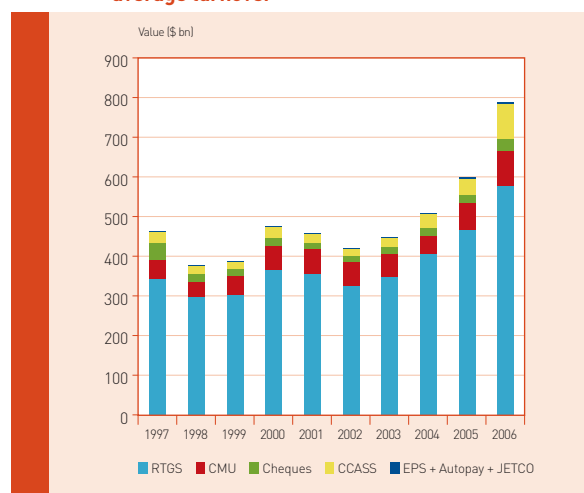
In addition to settling large-value payments, Hong Kong dollar CHATS also handles daily bulk clearings for the money settlement of stock market transactions, cheques and auto-debit transactions, low-value bulk electronic payment items (EPS and auto-credit), and low-value ATM transfers (Chart 1). The system was expanded in October to process bulk settlement for credit card transactions, removing the settlement risk for payments between the card-issuing banks and the merchant-acquiring banks.

REVIEW OF 2006

Hong Kong dollar interbank payment system

The Hong Kong dollar Clearing House Automated Transfer System (CHATS), which operates on a real-time gross settlement (RTGS) basis, is responsible for clearing all the Hong Kong dollar interbank payments. It has a direct link with the Central Moneymarkets Unit (CMU, the debt securities clearing and settlement system operated by the HKMA) to provide both real-time and end-of-day delivery-versus-payment settlement for transactions involving securities lodged with the CMU. Hong Kong Interbank Clearing Limited (HKICL), the system operator of Hong Kong dollar CHATS, was established in 1995 and is owned equally by the HKMA and the Hong Kong Association of Banks. In 2006, HKICL

Chart 1. Hong Kong dollar payment system daily average turnover



During the year, banks made good use of their Exchange Fund Bills and Notes to obtain interest-free intraday liquidity through intraday repurchase agreements with the HKMA to settle their interbank payments more efficiently. On average, intraday repurchase transactions amounting to \$49 billion were carried out daily to facilitate payment flows, representing 49% of the \$99 billion of Exchange Fund paper held by banks in December 2006.

US dollar CHATS

US dollar CHATS has been operating efficiently since its launch in 2000. The Hongkong and Shanghai Banking Corporation is the settlement institution, with HKICL as system operator. At the end of 2006, the system had 68 direct and 154 indirect participants, including 110 indirect participants from outside Hong Kong. On average, the system handled more than 7,000 transactions a day in

2006 with a total value of US\$6.3 billion (Chart 2).

Because of large IPO-related payments, the turnover of the US dollar CHATS reached a record high of US\$22.4 billion on 31 October. In addition, an average of more than 6,000 US dollar cheques with a total value of US\$180 million were processed daily.

Euro CHATS

Euro CHATS was launched in 2003. The settlement institution is Standard Chartered Bank (Hong Kong) Limited, with HKICL as system operator. At the end of 2006, there were 25 direct and 22 indirect participants, including 11 indirect participants from outside Hong Kong. In 2006, the system handled on average 99 transactions a day with a total value of over €1 billion (Chart 3).

Chart 2. US dollar clearing system daily average turnover

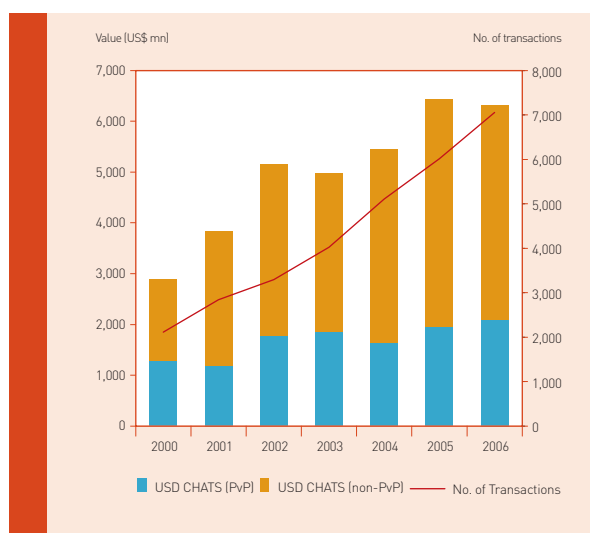


Chart 3. Euro clearing system daily average turnover



Payment links with the Mainland

In response to the increasing demand for cross-border payment services, the HKMA has been working closely with Mainland authorities to establish cross-border payment links. The development of these links is shown in Chart 4. Their use has risen gradually with the increasing economic integration between Hong Kong and the Mainland. The average daily turnover of cross-border payments handled by the various system links was over \$1 billion in 2006.

The RTGS system links with Shenzhen and Guangdong handled more than 19,000 transactions during the year, with a total value equivalent to over \$200 billion. Cross-border payments in Hong Kong dollars and US dollars between banks in Hong Kong and their counterparts in Shenzhen and Guangdong are settled effectively and safely through the system.

The cross-border two-way joint cheque clearing facilities cleared around 459,000 Hong Kong dollar and US dollar cheques, with a value equivalent to \$37 billion in 2006. The facilities shortened the clearing time for cheques drawn on banks in Hong Kong which were presented in Shenzhen and Guangdong, and vice versa. Since March,

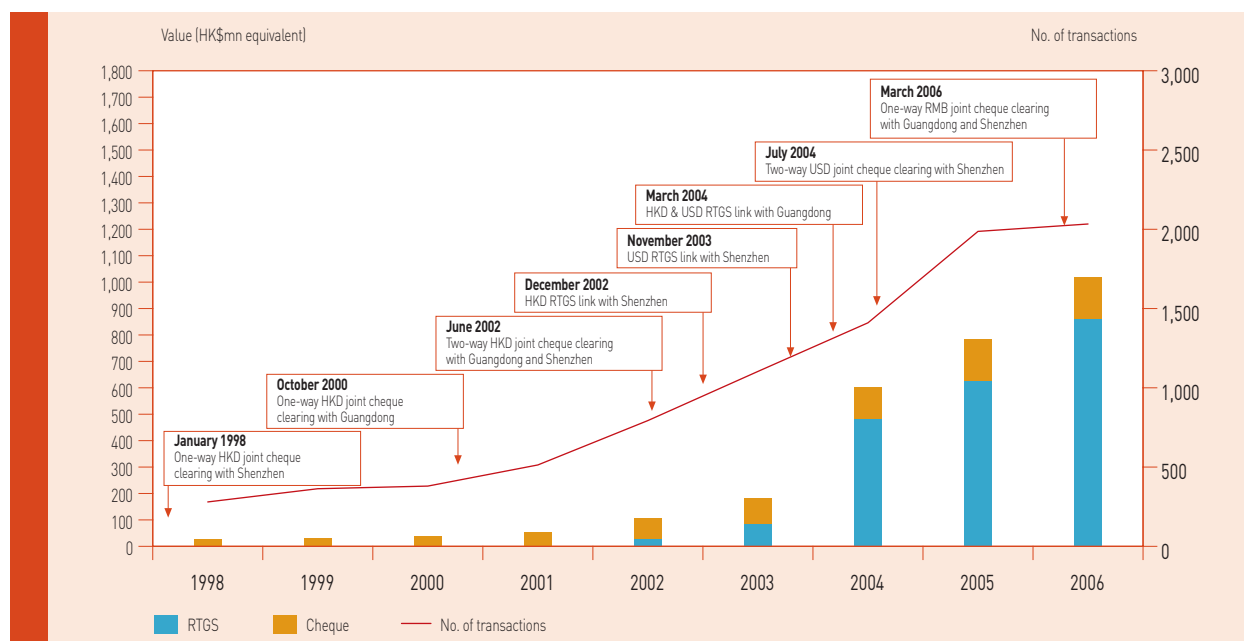
the joint cheque-clearing facilities have been expanded to cover renminbi cheques drawn on banks in Hong Kong and presented to banks in Shenzhen and Guangdong for consumer spending.

Debt settlement systems

The CMU provides an efficient, one-stop clearing, settlement and depository service for both Hong Kong dollar and other international debt securities. Since its establishment in 1990, the CMU has developed links with many regional and international central securities depositories. Through these links, overseas investors can hold and settle securities lodged with the CMU efficiently. It also helps Hong Kong investors to hold and settle foreign securities held with regional and international central securities depositories.

In 2006, the CMU processed a daily average of \$36 billion (148 transactions) in secondary market transactions. Among the debt securities lodged with the CMU at the end of the year, the outstanding amount of Exchange Fund Bills and Notes was \$131.8 billion and the amount of other securities was equivalent to \$265.3 billion.

Chart 4. Daily average turnover of cross-border links



Financial infrastructure review

The HKMA completed a comprehensive review of the financial infrastructure of Hong Kong in 2005. The purpose of the review was to develop a safe and efficient multi-currency, multi-dimensional clearing and settlement platform in Hong Kong and help turn Hong Kong into a regional payment and settlement hub. In 2006, the HKMA made encouraging progress in implementing the recommendations of the review.

Projects completed

CMU Bond Price Bulletin – this is a web-based platform (www.cmu.org.hk) providing retail investors with easily accessible information on bonds and indicative prices quoted by individual financial institutions. Launched in January 2006, the Bulletin helps promote retail investors' participation in the secondary market. At the end of 2006, indicative prices of about 160 bonds quoted by 11 financial institutions were available on the Bulletin.

RTGS Liquidity Optimiser – launched in January 2006, this new device enhances the efficiency of the RTGS system by settling interbank payments multilaterally every 30 minutes. Each of the transactions settled is still on a "gross" or "deal-by-deal" basis. The Optimiser helps reduce the intraday liquidity needs of the banks and clear payment instructions in the payment queues.

A mechanism for **Simultaneously Processing DvP and Collateralisation** of Exchange Fund Bills and Notes, established in January 2006, allows Exchange Fund Bills and Notes bought by a bank to be used as security for sale and repurchase agreements with the HKMA to obtain intraday liquidity to settle the bank's RTGS payments. This makes it easier for banks to manage their liquidity needs.

Renminbi Settlement System (RSS) – the RSS was launched in March 2006 to cater for the settlement

needs arising from expanded renminbi business in Hong Kong. The RSS can be quickly developed into a full RTGS system to support further expansion of renminbi business in Hong Kong. In 2006, the RSS handled 138 transactions a day on average with a total value of RMB38 million yuan.

Bulk settlement for credit card transactions – the service was launched in October 2006 to allow Hong Kong dollar credit card transactions to be settled between card-issuing banks and merchant-acquiring banks in bulk-settlement runs operated by HKICL. The arrangement mitigates settlement risk among the banks, making settlement more efficient. Credit card companies including VISA International, MasterCard International and China UnionPay have joined the arrangement.

Cross-Currency CHATS Optimiser – introduced in October, the Optimiser helps banks manage their liquidity during times of heavy fund flows such as during large IPOs. A bank can borrow Hong Kong dollars from a receiving bank of an IPO through a Hong Kong dollar/US dollar swap and, with the help of the Optimiser, use the Hong Kong dollars to settle its Hong Kong dollar cheques. The application monies of IPOs can therefore be recycled back to the market more efficiently, ensuring the smooth operation of the IPOs.

The link between Malaysia's ringgit RTGS system and Hong Kong's US dollar CHATS – the link was launched in November 2006. It helps eliminate settlement risk among Malaysian banks in foreign exchange transactions involving the US dollar and Malaysian ringgit by ensuring the simultaneous delivery of ringgits in Malaysia and US dollars in Hong Kong. It is the first cross-border PVP link established in Asia. The link has been operating smoothly since its launch and has proved popular with participating banks.

Projects in progress

Migration to SWIFTNet – this large-scale project will replace the existing proprietary platform of the various RTGS systems and the CMU with an open platform to improve compatibility with other clearing and settlement systems and facilitate system links, making it easier for overseas banks to use the RTGS systems in Hong Kong. This is an important project to help develop Hong Kong into a regional payment and settlement hub. The migration is expected to take place in 2008.

Cross-border correspondent banking – Many international banks are direct participants in the US dollar CHATS in Hong Kong. These banks have their own networks of correspondent banks in the region. As part of the strategy to develop Hong Kong into a regional payment hub, the HKMA is trying to use the US dollar CHATS to pool these networks of correspondent banks and encourage them to settle their commercial payments through Hong Kong. Modifications to the systems to facilitate this are scheduled for completion by the third quarter of 2007.

Business development

In addition to the system development projects, the financial infrastructure review identified the need to link Hong Kong's RTGS systems and the CMU with other clearing and settlement systems in the region, and to promote greater use of the clearing and settlement systems in Hong Kong. As a result, the HKMA has established a comprehensive marketing programme to pursue these objectives through seminars and visits to

potential users in the Asia Pacific region. In 2006, over 160 marketing calls were made.

Promoting links with other Asian economies –

extensive links with the clearing and settlement systems of other economies help develop Hong Kong into a payment and settlement hub for the region. Building on the success of the PvP link with Malaysia, the HKMA is exploring opportunities with other Asian economies to establish cross-border links with their clearing and settlement systems. For instance, the HKMA hosted a central securities depository workshop in March to explore how the central securities depositories in the region could use the US dollar CHATS in Hong Kong for their US dollar settlement. The workshop was attended by over 20 representatives from central securities depositories in the region. It helped establish contacts with other central banks and system operators in the region and develop system links.

Promoting the use of Hong Kong's clearing and settlement platform –

marketing calls were made to and seminars held in a number of Asian economies, including Indonesia, Malaysia and Taiwan, to promote the use of Hong Kong's multi-currency clearing and settlement platform. In addition, the HKMA organised jointly with the People's Bank of China two seminars in Beijing and Shanghai in June to encourage Mainland financial institutions to use Hong Kong's platform to settle the foreign currency legs of foreign exchange transactions. A number of banks on the Mainland have started to settle the US dollar legs of their foreign exchange transactions in Hong Kong.

 > Financial Infrastructure > Infrastructure

Oversight of clearing and settlement systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO), which came into force in November 2004, 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 designated systems including the Central Moneymarkets Unit, Hong Kong dollar CHATS, US dollar CHATS, Euro CHATS and the Continuous Linked Settlement (CLS) System. Except for the CLS System, the HKMA oversees the designated systems through off-site reviews and continuous monitoring, on-site examinations and meetings with management. In 2006, all designated systems were found to be in compliance with the safety and efficiency requirements under the CSSO.

Designated systems are encouraged to comply with international best practices. In 2006, the HKMA conducted an assessment of Euro CHATS against the internationally-recognised standards provided by the Core Principles for Systemically Important Payment Systems¹. The assessment, which was published to promote transparency, concluded that Euro CHATS generally observed the Core Principles.

Co-operative oversight arrangements

In a globalised economy, clearing and settlement systems have become increasingly inter-dependent, leading to the establishment of co-operative oversight arrangements.

The CLS System, a designated system in Hong Kong, is operated by CLS Bank, which is primarily regulated by its home supervisor, the US Federal Reserve. The HKMA and other central banks (including the US Fed) participate in the international co-operative oversight arrangement of the CLS System.

Following the establishment in November of the US dollar/ringgit PvP link between the US dollar CHATS in Hong Kong and RENTAS in Malaysia, the HKMA and Bank Negara Malaysia established a co-operative oversight arrangement for the PvP link in December. Under the arrangement, an information sharing mechanism was set up through which the two parties alert each other about issues that may affect the smooth operation of the link.

The central banks of the G10 countries agreed that SWIFT, an important global message carrier for payment systems incorporated in Belgium, should be subject to co-operative oversight by central banks, with the National Bank of Belgium as the lead overseer. As the CMU accepts SWIFT messages and all the local designated systems will migrate to the SWIFTNet platform in 2008, the HKMA has an interest in the oversight of the system. In 2006, the HKMA monitored the development of SWIFT's oversight framework and was involved in related discussions with other central banks and bilateral meetings with the National Bank of Belgium.

Independent tribunal and committee

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

¹ The Core Principles were developed by the Committee on Payment and Settlement Systems of the Bank for International Settlements in 2001.

An independent Process Review Committee was established in December 2004 to review 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. An Internal Operating Manual setting out the procedures for evaluating the designated systems' compliance with the oversight standards was revised in 2006 based on the HKMA's first-year oversight experience, and was endorsed by the Committee. The Committee uses the procedures in the Manual as the benchmark to assess whether the HKMA has applied the same set of procedures to all designated systems. Quarterly reports and management reports summarising the HKMA's oversight activities, were submitted to the Committee.

The Committee held two meetings in 2006, reviewing four quarterly reports and 22 accompanying oversight activities management reports of the designated systems. The Committee concluded that it was not aware of any cases 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 reports, which are available on the HKMA's website, to the Financial Secretary.

Informal oversight of retail payment systems

Compared with large-value interbank payment systems, the retail payment systems generally carry little, if any, 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 their safety and efficiency.

In August 2005, the HKMA endorsed the Code of Practice for Multi-purpose Stored Value Card Operation issued by Octopus Cards Limited (OCL), the system's operator. Since then, the HKMA has monitored OCL's compliance with the Code, and OCL completed its first self assessment in 2006.

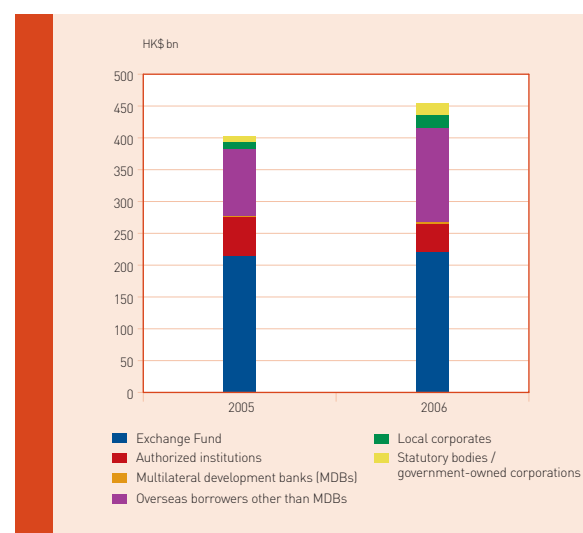
In December, a Code of Practice for Payment Card Scheme Operators was drawn up and issued by eight credit and debit card scheme operators with the support of the HKMA. The Code, which became effective on 1 January 2007, sets out the principles covering operational reliability, data and network security, and the efficiency and transparency of payment card operations in Hong Kong. The HKMA will monitor the operators' compliance with the Code.

 > Financial Infrastructure > Oversight

Debt market development

Gross issuance of Hong Kong dollar debt rose further in 2006 and reached \$454 billion for the year, compared with \$402 billion in 2005 (Chart 5). Overseas borrowers, other than multilateral development banks (MDBs), were the second most active issuers in the primary market after the Exchange Fund, issuing \$147 billion of debt in 2006, an increase of 39% from the previous year. Gross issuance by authorized institutions, however, decreased by 28% to \$45 billion, probably reflecting ample liquidity in the banking system and reduced need for the banks to raise funds in the debt market.

Chart 5. New issues of Hong Kong dollar debt instruments



The value of outstanding Hong Kong dollar debt rose to \$748 billion at the end of 2006 from \$664 billion in 2005, a 13% increase (Chart 6). Overseas borrowers, other than the MDBs, were the largest group of borrowers in the local debt market with outstanding debt amounting to \$332 billion. The outstanding debt issued by authorized institutions decreased by 4% to \$147 billion at the end of 2006.

Exchange Fund Bills and Notes programme

The HKMA completed a review of the EFBN programme in 2006. A number of recommendations aimed at improving market efficiency were identified:

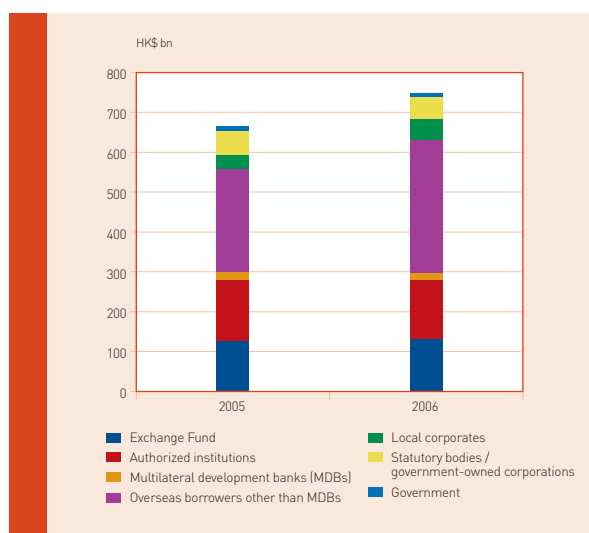
- (1) refining the market-making system for EFBNs by providing incentives to encourage market makers to trade EFBNs more actively. The incentives include publishing league tables of the active market makers, inviting only the more active ones to participate in tenders and exploring the adoption of single-price auctions to replace the existing multiple-price auctions;
- (2) extending the benchmark EFN yield curve to beyond 10 years by issuing longer-dated paper;

- (3) streamlining the issuance programme by re-opening more existing EFN issues to increase the size of benchmark issues and improve liquidity in the secondary market of these issues; and
- (4) introducing an electronic trading platform to facilitate trading and increase the transparency of prices and transactions.

The first set of league tables, ranking market makers according to their turnover in EFBs and EFNs between June and November 2006, was released in December. The other recommendations are being implemented.

As part of the review, the HKMA also reconsidered the three-year rule introduced in September 1998, which requested the MDBs to confine their issuance of Hong Kong dollar denominated bonds to tenors of three years or longer to help maintain monetary stability during the Asian financial crisis. With the introduction of the seven technical measures in 1998 and the three refinements to the Linked Exchange Rate system in 2005, the HKMA is now better equipped to deal with potential speculative attacks on the Hong Kong dollar. Lifting of the three-year rule is therefore unlikely to pose a serious threat to

Chart 6. Outstanding amount of Hong Kong dollar debt instruments



monetary stability. Following a review by the Currency Board Sub-Committee, the three-year rule was withdrawn on 9 October 2006. The MDBs may now issue Hong Kong dollar debts of short maturities and this will help develop the local debt market.

Apart from implementing the recommendations of the debt market review, the HKMA continued in 2006 to improve the credibility of the benchmark Hong Kong dollar yield curve to promote market development and facilitate the pricing of private and public-sector debt issues. In particular, the re-balancing of the maturity distribution of the EFBNs continued with more longer-end notes being issued. Reflecting this, the share of EFBNs with remaining maturity of more than three years increased to 19% in 2006 from 16% in 2005 (Table 1). To promote retail participation in the debt market, the HKMA made four retail issues of EFNs in 2006. The issues were well received by the public and \$785 million of two-year EFNs were issued, compared with \$500 million in 2005.

Table 1. Outstanding issues of Exchange Fund Bills and Notes

	2005	2006
(in millions of Hong Kong dollars)		
Exchange Fund Bills (by original maturity)		
91 days	36,209	36,288
182 days	16,900	16,900
364 days	16,900	16,900
Sub-total	70,009	70,088
Exchange Fund Notes (by remaining tenor)		
1 year or below	12,600	14,400
Over 1 year and up to 3 years	23,400	22,600
Over 3 years and up to 5 years	10,600	14,000
Over 5 years and up to 7 years	6,800	6,800
Over 7 years	3,300	3,900
Sub-total	56,700	61,700
Total	126,709	131,788

 > Financial Infrastructure > Debt Market Development

Treasury Markets Association (TMA)

The Association, chaired by the HKMA's Deputy Chief Executive, Mr Y K Choi, completed its first full year of operation since its establishment in November 2005. The HKMA continued to provide strategic support to the TMA, working with it to achieve its objective of developing Hong Kong as the hub for treasury market business in the region. Encouraging results were achieved during 2006:

- **Membership:** over 2,000 individual and 74 institutional members from virtually all sectors of the Hong Kong treasury markets had joined the TMA by the end of the year.
- **Qualifications:** the TMA developed two new certificates, the Treasury Markets Certificate and the Treasury Markets (Debt Securities) Certificate in collaboration with the Hong Kong Institute of Bankers and the University of Science and Technology respectively. The two certificate programmes, designed to equip new entrants with essential treasury markets knowledge, serve as an admission requirement for TMA members.
- **On-the-job training:** over 30 seminars, workshops, and talks were organised as continuing education opportunities for both individual members and the staff of institutional members to increase the knowledge and professionalism of market practitioners.
- **New market instruments:** the TMA worked closely with market participants to launch new products and services to facilitate market development. In response to market demand, the TMA launched the spot USD/HKD fixing in April as a benchmark for market exchange rates of US dollars against Hong Kong dollars. The Association also developed the Renminbi Non-deliverable Interest Rate Swap in August to help corporations and financial institutions outside the Mainland to manage their renminbi interest rate exposure.

- **Raising the profile of the Hong Kong treasury markets:** to maintain Hong Kong's position as the hub for regional treasury activities, the TMA maintained close contacts with overseas counterparts by taking part in key international industry and market forums. In view of the rapid growth of the Mainland treasury markets and increasing integration of the Mainland and the Hong Kong economies, the TMA put considerable effort into promoting Hong Kong's treasury markets to its Mainland counterparts and financial institutions.

PLANS FOR 2007 AND BEYOND

One of the priorities in 2007 is to implement the remaining recommendations identified in the financial infrastructure review to build a safe and efficient multi-currency, multi-dimensional clearing and settlement platform, and facilitate the development of Hong Kong into a regional payment and settlement hub. The HKMA will monitor the progress of the SWIFTNet migration and the cross-border correspondent banking projects closely to ensure that they can be completed on schedule. The HKMA will continue to ensure the safe and efficient operation of the RTGS systems and the CMU, which are instrumental to maintaining the stability and integrity of the monetary and financial systems in Hong Kong.

As part of the effort to develop Hong Kong into a regional payment and settlement hub, the HKMA will explore opportunities to link Hong Kong's clearing and settlement systems with their counterparts in the region. Marketing efforts to promote the use of Hong Kong's clearing and settlement platform and cross-border correspondent banking services by banks in the region and on the Mainland will continue.

Following the State Council's approval for the issuance of renminbi bonds in Hong Kong by Mainland financial institutions, the HKMA will move ahead to upgrade the Renminbi Settlement System to cope with the settlement needs arising from the new business.

As the overseer of designated systems under the CSSO, the HKMA will continue to be involved in promoting the safety and efficiency of these systems. Following the assessment of Euro CHATS against the Core Principles in 2006, the HKMA will perform the same assessment on the Hong Kong dollar CHATS and US dollar CHATS in 2007.

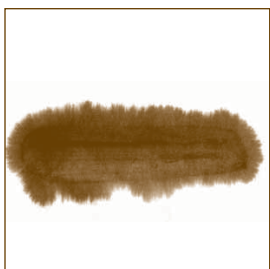
Amendments to the clearing house rules are expected to be completed by early 2007 to extend the coverage of Hong Kong dollar CHATS and US dollar CHATS to include small-value interbank payment items such as paper cheques. This will bring all types of interbank payments under the statutory oversight regime of the HKMA.

A self-regulatory approach for retail payment systems has been implemented through the successful launch of two Codes of Practice covering multi-purpose stored value cards, and credit and debit cards. The HKMA will continue to monitor the operators' self-compliance with their Codes.

The HKMA will continue to monitor the developments in the payment industry in Hong Kong and participate in international forums to keep abreast of global trends in the oversight of payment systems, and make improvements where necessary.

On the development of the debt market, the priority is to implement the recommendations arising from the review of the EFBN market. The HKMA also plans to further study other issues relating to the development of the local debt market. These include the investor base and issuer base of the market, regulation and taxation, and market microstructure, such as the trading mechanism and the price discovery process.

The HKMA will also work closely with the TMA to develop Hong Kong's treasury markets, further improve the professionalism of market professionals, establish market practices consistent with international standards, launch new products and services to meet emerging market demands, and promote Hong Kong's treasury markets to the Mainland.



International Financial Centre

The HKMA's involvement in a range of initiatives during 2006 helped consolidate Hong Kong's position as a leading international financial centre. A "1-3-5 financial development blueprint" was prepared to foster closer financial co-operation with the Mainland. Considerable progress was achieved in expanding renminbi business in Hong Kong, paving the way for the issuance of renminbi-denominated bonds in Hong Kong by approved Mainland financial institutions. And Hong Kong's credit rating was upgraded to the AA category, the highest rating ever assigned to Hong Kong.

OVERVIEW

Developments in Mainland China were significant for both the international financial system and the status of Hong Kong as an international financial centre. The Mainland's 11th Five-Year Plan, promulgated in March 2006, sets out the policy direction for expediting financial reforms. With its foreign exchange reserves surpassing US\$1 trillion, the Mainland introduced a liberalised framework for portfolio investment outflows, known as the Qualified Domestic Institutional Investors (QDII) Scheme.

Against this backdrop, the HKMA improved its research and monitoring of regional and Mainland economic and financial issues to promote greater financial stability in Asia including Hong Kong. Its leadership of, and participation in, regional co-operation initiatives on bond market development, monitoring of cross-border fund flows and crisis management were further strengthened during the year. The HKMA developed a "1-3-5 financial development blueprint" for fostering closer financial co-operation and building bigger markets both in Hong Kong and on the Mainland. Further expansion of renminbi business was achieved through collaboration with the Mainland authorities. The participation of the HKMA in these co-operative efforts in the region and on the Mainland will help reinforce Hong Kong's position as a leading financial centre and as China's international financial centre.

REVIEW OF 2006

Regional co-operation and participation in multilateral institutions

In promoting greater monetary and financial co-operation in Asia, the HKMA contributed to regional initiatives on the development of the bond market and improving monetary and financial stability in the region. The HKMA also undertook detailed research on further strengthening the monitoring of regional issues for discussion at international and regional forums and explored initiatives for Asian financial co-operation in crisis management.

Internationally, the HKMA attended meetings of the Asia-Pacific Economic Co-operation (APEC) forum, the Financial Stability Forum and the Bank for International Settlements. Its contributions at these forums enabled delegates to understand more about monetary and financial issues in Asia and Hong Kong.

The HKMA and the World Bank co-organised a conference, *East Asian Financial Markets: the Next Frontier in Hong Kong*, in June 2006 to discuss steps to speed up the development of regional financial markets and promote greater financial integration within Asia. More than 100 representatives from regional central banks, regulatory bodies, international financial institutions and the private sector participated in the conference.

Promoting bond market development in Asia

In 2006, the Asian Bond Fund 2 (ABF2) initiative under EMEAP reached another milestone in attracting private investments. Three component funds were offered to the public — the Single-market Fund of Thailand, an exchange traded fund, and those of Korea and the Philippines, which are unlisted open-ended funds. With four previously listed component funds — the ABF Pan Asia Bond Index Fund (PAIF) and the Single-market Funds of Hong Kong, Malaysia and Singapore — seven component funds have now been launched. Private investment in these ABF2 funds now accounts for 23.7% of their total assets, which reached US\$3.0 billion by the end of 2006, representing growth of nearly 50% above the US\$2 billion seed money injected by EMEAP in the second quarter of 2005. By the end of 2006, the PAIF, which invests in local-currency denominated sovereign and quasi-sovereign bonds issued in eight EMEAP markets¹, had achieved a total return of 14.3% since its listing in Hong Kong in July 2005, outperforming similar funds during the period.

The HKMA, as chair of the EMEAP Working Group on Financial Markets, led a review of the ABF2 Initiative and published the findings in June. The review concluded that the ABF2 funds, which are structured as passively managed bond index funds with low subscription and recurrent costs, appealed especially to foreign institutional investors. The ABF2 Initiative also helped identify the key impediments to cross-border investment flows in the region and promoted the introduction of regulatory, legal and tax reforms to remove some of these impediments. Larger intra-regional capital flows, facilitated by the ABF2 Initiative, helped build bigger bond markets and promote financial stability in Asia. Following this important first step, more efforts are needed to resolve outstanding issues, such as the harmonisation of

regulatory approaches and the promotion of mutual recognition of financial intermediaries and products.

Upgrading Hong Kong's sovereign credit rating

The HKMA worked with the Government to foster a better understanding of Hong Kong's economic and financial strengths among international credit rating agencies (CRAs). Quantitative analysis by the HKMA indicated that Hong Kong's creditworthiness viewed in isolation was comparable to that of AAA-rated economies. Rigorous stress tests using an econometric model suggested that Hong Kong could withstand significant economic shocks from the Mainland.

This strategy proved to be effective and contributed to a number of upgrades in 2006, with Hong Kong elevated to the AA category by all major international CRAs — the highest rating ever assigned to Hong Kong. The upgrades reflected international recognition of Hong Kong's strong economic fundamentals, improved public finances and growth prospects. In a comparative study published in January 2007, Standard and Poor's acknowledged that Hong Kong's credit strengths were comparable with those of many economies with AAA ratings.

Financial co-operation with the Mainland

During the year, a key focus of the HKMA's work was the formulation of a strategy to improve Hong Kong's status as an international financial centre through close co-operation with the Mainland in light of its financial developments and reforms. The HKMA prepared a "1-3-5 financial development blueprint", which was adopted as part of the report of the Focus Group on Financial Services set up under the HKSAR Chief Executive's Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong" in September.

¹ China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand.

“1-3-5 financial development blueprint” — a proposal for closer financial co-operation between Hong Kong and the Mainland

Under the “One Country, Two Systems” arrangement, China is unique in having two different financial systems in Hong Kong and the Mainland. This provides a great deal of scope for financial co-operation. For Hong Kong, the main issue is how to play a bigger role in the Mainland’s financial development and reforms, while strengthening its status as China’s international financial centre.

What Hong Kong can offer

The Mainland’s 11th Five-Year Plan, which outlines the policies to be pursued from 2006 to 2010, was promulgated in March 2006. Chapter 33 of the Plan sets out clearly the policy direction for expediting financial reform and the related measures in four main areas: deepening the reform of financial enterprises and improving corporate governance of financial institutions; speeding up the development of direct financing channels, such as the equity and bond markets and gradually developing futures markets; enhancing the mechanisms for financial and monetary control and management, which includes developing money markets and gradually introducing renminbi convertibility for capital account items; and improving financial sector supervision.

Hong Kong, with its efficient financial platform, reliable financial infrastructure and a supervisory framework of international standard, can contribute in three main aspects. First, by gradually linking the two financial markets, Hong Kong can provide diversified financial services for the Mainland, help make the Mainland’s financial intermediation more efficient, and act as a catalyst for the development of the Mainland’s financial centres. Secondly, Hong Kong can be used as a platform for the Mainland’s policy of allowing orderly and prudent increases in capital outflows, helping the Mainland achieve better external balances. Thirdly, with Mainland China now one of the world’s largest economies, increased use of the renminbi outside the country is inevitable. Since 2004, Hong Kong has acquired experience in conducting renminbi business, and is able

to provide a robust and reliable testing ground for an increased use of the renminbi outside the Mainland.

The 1-3-5 blueprint

A blueprint was therefore developed for fostering closer financial co-operation, building bigger markets both in Hong Kong and on the Mainland and positioning Hong Kong as China’s international financial centre.

- **From a strategic perspective, one positioning:** to develop Hong Kong as the country’s international financial centre of global significance. This will provide China with an efficient financial intermediation platform to support the sustainable growth of a large economy and avoid the payment and settlement risks associated with international financial activities in different time zones. The large differences in risk attributes and appetites of market participants should facilitate risk transfer and management. With such a financial centre, China’s contribution to the formulation of global financial standards and policies should increase.
- **From an institutional perspective, three dimensions:** to establish a complementary, co-operative and interactive relationship between the financial systems of Hong Kong and the Mainland. Complementary means the respective strengths of the two financial systems are exploited and the weaknesses of one system are addressed by the other; co-operative means the two financial systems can benefit from closer collaboration in areas such as financial supervision, financial infrastructure, and risk management, through technical transfers, information exchange, qualification recognition and harmonisation of standards; interactive means the two financial systems should interact to boost China’s role in international finance, make financial intermediation more efficient and promote the development of financial markets within the country.

- **From a practical perspective, five areas:** to act as a catalyst for the development of financial centres in the Mainland through: expanding the presence of Hong Kong financial institutions on the Mainland; increasing the outward mobility of the Mainland's investors, fund-raisers, financial institutions and instruments through Hong Kong; allowing Hong Kong financial instruments to be traded on the Mainland; strengthening Hong Kong's capability to handle financial transactions denominated in renminbi; and strengthening

financial infrastructural links between Hong Kong and the Mainland.

"Continuing to promote financial co-operation between Hong Kong, Macao and the Mainland" was specified as one of the important tasks by the National Finance Working Meeting, which concluded in January 2007. Discussions will be held with the Mainland authorities to work out implementation proposals based on the "1-3-5 financial development blueprint".

Renminbi business in Hong Kong, which was launched in early 2004, is part of the "1-3-5 financial development blueprint". At the end of 2006, renminbi deposits totalled RMB22.7 billion yuan in more than 450,000 accounts. Renminbi banking services are now offered by 38 banks, representing almost all retail banks in Hong Kong.

Considerable progress was made during the year with the Mainland authorities on proposals to further expand renminbi business in Hong Kong. On 10 January 2007, the State Council announced its agreement for Mainland financial institutions, after obtaining approval, to issue renminbi-denominated bonds in Hong Kong. This will create a new asset class for renminbi depositors in Hong Kong to invest in. It will also be the first time that non-Mainland individuals are able to invest directly in renminbi-denominated bonds. Banks in Hong Kong will be able to diversify their renminbi assets and enjoy new business opportunities for the sale and distribution of renminbi bonds. The issuance of renminbi bonds in Hong Kong will also serve as a pilot for the use of renminbi for financial transactions outside the Mainland.

Co-operation with Mainland financial regulators was strengthened in 2006. The Joint Meeting on Bank QDII (offshore wealth management services by banks on the Mainland) between the China Banking Regulatory Commission (CBRC), the State Administration of Foreign Exchange, the HKMA and the Securities and Futures Commission was convened for the first time in

December. The meeting discussed issues relating to product development and supervisory co-operation.

Strengthening research on Mainland economic and financial issues

Closer economic and financial integration means that developments in the Mainland will have increasing implications for Hong Kong in both financial stability and its role as an international financial centre. A dedicated research series, *China Economic Issues*, was introduced in 2006 to build on existing in-house monitoring and analytical work as well as research exchanges with Mainland academics and think-tanks. The series provides detailed analysis of economic and financial market issues on the Mainland. Various topics were studied, including the Mainland's interest rate structure, development of renminbi derivatives and commodity futures markets, the impact of renminbi exchange rate movements on the macroeconomy, and the role of exchange rates in macroeconomic control.

 > [China Economic Issues](#)

Training

Training programmes for officials of the People's Bank of China, the CBRC and other Mainland authorities in Hong Kong and on the Mainland continued to expand in 2006, both in scope and numbers of people involved. These courses covered financial stability, banking supervision, accounting management, market analysis, financial risk management, prevention of money laundering and

human resources management. Twenty courses, or 2,743 man-days of training, were provided to 1,389 Mainland officials.

The HKMA also provided training on request to other external parties, including courses for Mainland government officials and Mainland commercial banks, and a regional course on Fundamentals of Interest Rate Risk Management under the APEC financial regulators' training initiative. More than 200 participants attended these seminars in 2006.

PLANS FOR 2007 AND BEYOND

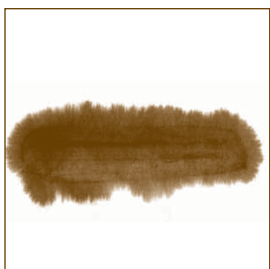
The HKMA will further strengthen its research and monitoring on monetary and financial developments in Asia, particularly the Mainland, and will ensure the views and concerns of Hong Kong are heard in central banking and international financial forums. Participation in regional co-operative and market development initiatives will remain a priority in 2007 to promote financial stability in Asia and strengthen Hong Kong's status as the leading financial centre in the region.

Having pursued a number of rating upgrades in 2006, the HKMA will refine its focused strategy towards the international CRAs to secure further upgrades of Hong Kong's credit ratings. The key objective is to make sure that the CRAs have a balanced and up-to-date view of Hong Kong.

Hong Kong is likely to play a more prominent role in financial matters on the Mainland, and in positioning itself as China's international financial centre of global significance as integration of the two economies intensifies. The HKMA, together with the Government, will continue to work with the Mainland authorities in implementing the "1-3-5 blueprint". With the recent agreement to introduce renminbi-denominated financial bonds in Hong Kong, the HKMA will launch a renminbi Real Time Gross Settlement system to facilitate the new business. Monitoring the economic, financial and monetary developments on the Mainland and understanding the implications for Hong Kong will be an important task for the HKMA. The HKMA will continue to strengthen co-operation with Mainland regulators and organise training seminars and courses for the staff of Mainland authorities and other external parties.

 > [Monetary Stability](#) > [International Relations](#)

 > [Press Releases](#) > [International Relations](#)



Reserves Management

In 2006, the Exchange Fund achieved an investment return of 9.5%, or 0.6% above that of the investment benchmark, amid volatile financial markets. The year saw monetary tightening, rising energy and commodity prices, and a shift in investors' attention from the traditional US and European markets to emerging economies, particularly China and India. Global equity markets continued to show remarkable gains against a backdrop of ample liquidity and tight credit spreads, while the bond markets recovered in the latter half of the year. Although the US dollar lost its shine in the foreign exchange market, weakening against the euro by 10.5%, it finished the year stronger against the yen.

THE EXCHANGE FUND

The primary objective of the Exchange Fund, as laid down in the Exchange Fund Ordinance, is to affect, either directly or indirectly, the exchange value of the currency of Hong Kong. In addition, it can be used to maintain 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. Because of the need to meet these statutory objectives, the Exchange Fund is different from a typical investment fund and it is not appropriate to compare directly the investment results of the Exchange Fund with those of other investment funds, whose key investment objective is to maximise returns.

MANAGEMENT OF THE EXCHANGE FUND

The Exchange Fund Ordinance

The Ordinance provides for the establishment and management of the Exchange Fund. According to the Ordinance, the Exchange Fund is under the control of the Financial Secretary, and may be invested by him in any securities or other assets he, after having consulted the Exchange Fund Advisory Committee (EFAC), considers appropriate.

Investment objectives and benchmark

The Exchange Fund's long-term asset allocation strategy is governed by the investment benchmark approved by the Financial Secretary after consultation with EFAC. The investment benchmark represents the optimal mix of assets designed to meet the following investment objectives endorsed by EFAC:

- (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 preserve the long-term purchasing power of the Fund.

According to the investment benchmark, the Exchange Fund is divided into two distinct portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio holds highly liquid US dollar-denominated securities to provide full backing to the Monetary Base as required under the Currency Board arrangements. The balance of the Exchange Fund is held in the Investment Portfolio, which 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. Under the current benchmark, 77% of the Exchange Fund is allocated to bonds and 23% to equities and related investments. In terms of its exposure in the foreign exchange market, 88% of the Exchange Fund is allocated to the US dollar bloc (including the Hong Kong dollar) and the remaining 12% to other currencies.

The investment process

The Exchange Fund's investment strategy is determined by the Financial Secretary on the advice of EFAC, while the day-to-day management of the Fund is conducted by the Reserves Management Department (RMD) of the HKMA. In discharging its responsibilities, RMD operates within the investment guidelines endorsed by EFAC.

While the Financial Secretary determines the investment benchmark after consultation with EFAC, he also approves the limits within which the HKMA can deviate from the benchmark to take advantage of market movements in order to achieve a return that is higher than the benchmark return¹. Such a return is known as an active return, or alpha. The investment managers of RMD monitor the global investment markets and identify suitable investment opportunities to achieve a positive alpha by exercising discretion under the delegated authority to deviate from the investment benchmark. Since the investment benchmark was established in 1999, the Exchange Fund has achieved an average positive alpha of 1.2% a year.

Use of external managers

In addition to managing assets internally, the HKMA also employs external fund managers, located in over a dozen international financial centres, to manage about one third 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 transferring knowledge and information from the market to in-house professionals.

In 2006, the HKMA completed a review of its policy on the use of external managers. It concluded that external managers had benefited the management of the Exchange Fund with their complementary investment capabilities for certain approved asset classes and product types. As a result of the review, additional external managers were appointed to manage portfolios in a wider range of asset classes and markets to achieve more diversified investments and to improve long-term returns for the Exchange Fund. The appointments of some external managers with less complementary roles were terminated and the portfolios were transferred back to in-house management. While on the whole there has been an increase in management fees, the appointment of external managers plays a strategic role in helping diversify the Exchange Fund into more sophisticated asset markets and improve its return in the long run.

Equity portfolios

The management of the Hong Kong equity portfolios was transferred to the HKMA in January 2003 from Exchange Fund Investment Limited. The HKMA manages these portfolios, and its other foreign equity portfolios, exclusively through external fund managers.

Risk management and compliance

The high volatility in the financial markets in recent years has highlighted the importance of risk management in the investment process. Stringent controls and investment guidelines have been established for both internally and externally managed portfolios. Risk-control tools are also deployed to assess market risks incurred by the various investment portfolios under both normal and extremely 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.

¹ The benchmark return for any accounting period is the return achieved by the benchmark portfolio during that period, assuming that the benchmark allocation of assets is strictly followed throughout the period without deviation. The benchmark return can therefore only be calculated after the completion of an accounting period.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2006

2006 was a difficult year for bond investments because continued monetary tightening by the major central banks drove bond yields significantly higher in the first half of the year. The US Fed funds target rate reached 5.25% at the end of June 2006, after four rounds of tightening during the year, although signs of weakening growth in the US subsequently led to a pause in the increase in interest rates. The European Central Bank raised rates by a cumulative 125 basis points in 2006, bringing the key policy rate to 3.5%. The Bank of Japan ended its five-year quantitative easing policy and announced a 0.25% tightening on 14 July 2006, and the Bank of England raised interest rates twice taking the base rate to 5%.

The 10-year US Treasury bond yield peaked at 5.25% in mid-2006 before gradually easing to around 4.7% by the end of the year, while other major bond markets closely followed the US bond yield movements. The Treasury yield curve remained inverted throughout 2006.

Global equity markets made notable gains in 2006, driven mainly by investors' aggressive search for higher returns in a relatively low-yield environment. The US and the major European stock markets ended the year higher by more than 10%. The Hang Seng index rose by an impressive 34% in 2006, underpinned by the appreciation of the renminbi and record IPO activities in Hong Kong.

It was a mixed picture for the US dollar in the foreign exchange market in 2006. Rumours of major central banks divesting into non-dollar assets provided strong support for the euro, which appreciated by 11.8% against the US dollar. The yen, however, weakened by 0.9% against the US dollar, apparently penalised by the wide interest rate gap between the two currencies.

The performances of major bond, equity and currency markets in 2006 are shown in Table 1.

The Exchange Fund's performance in 2006

The Exchange Fund earned a gross investment income of \$103.8 billion in 2006, comprising \$31.9 billion from bond investments, \$35.9 billion from Hong Kong equities, \$18.7 billion from foreign equities, and a foreign exchange revaluation gain of \$17.3 billion. The total investment income represented an investment return of 9.5%, which was 0.6% better than the return of the investment benchmark for the year. This active return, or alpha, was the fifth highest since 1999, when the investment benchmark for the Exchange Fund was established.

Table 2 shows the annualised investment return of the Exchange Fund relative to the investment benchmark and domestic inflation from 1994 to 2006. The annual return of the Exchange Fund from 1994 to 2006 is set out in Chart 1. The comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2006 is shown in Chart 2. Since 1994, the Exchange Fund has generated a compounded annual return of 6.6%, which compares favourably with the compounded annual inflation rate of 1.3% over the period. Table 3 shows the currency mix of the Fund's assets on 31 December 2006.

Table 1. 2006 market returns

Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+11.8%
Yen	-0.9%
Bond markets	
US Government Bond (1-3 years) Index	+3.9%
Equity markets	
Standard & Poor's 500 Index	+13.6%
Hang Seng Index	+34.2%

Table 2. Gross investment return of the Exchange Fund in Hong Kong dollar terms ¹

	Return on total assets	Return on investment benchmark ²	Alpha	CPI(A) ³
2006	9.5%	8.9%	+0.6%	+1.9%
2005	3.1%	2.9%	+0.2%	+1.3%
1999 – 2006 annualised	6.2%	5.0%	+1.2%	-1.0%
1994 – 2006 annualised	6.6%	N/A	N/A	+1.3%

¹ For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US dollar terms.
² Established in January 1999.
³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 2004/2005 base new series.

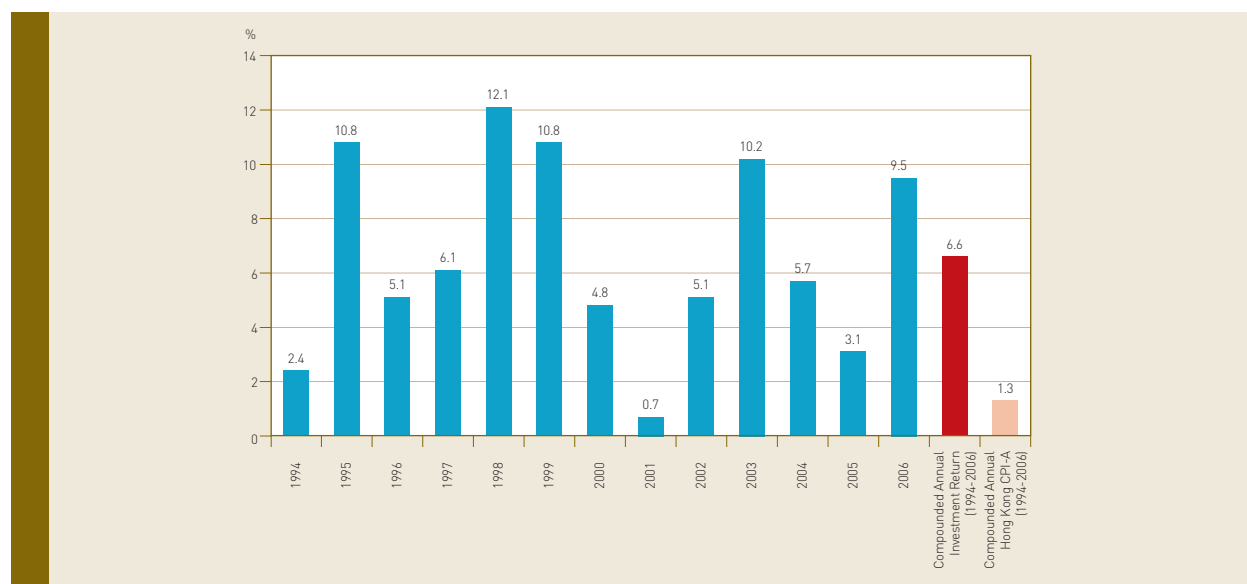
Table 3. Currency mix of the Exchange Fund's assets on 31 December 2006 – including forward transactions

	HK\$ billion	%
US dollar bloc		
US dollar ¹	909.8	77.4
Hong Kong dollar	130.9	11.1
Non-US dollar bloc	135.7	11.5
Total	1,176.4	100.0

¹ Includes US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

Transparency

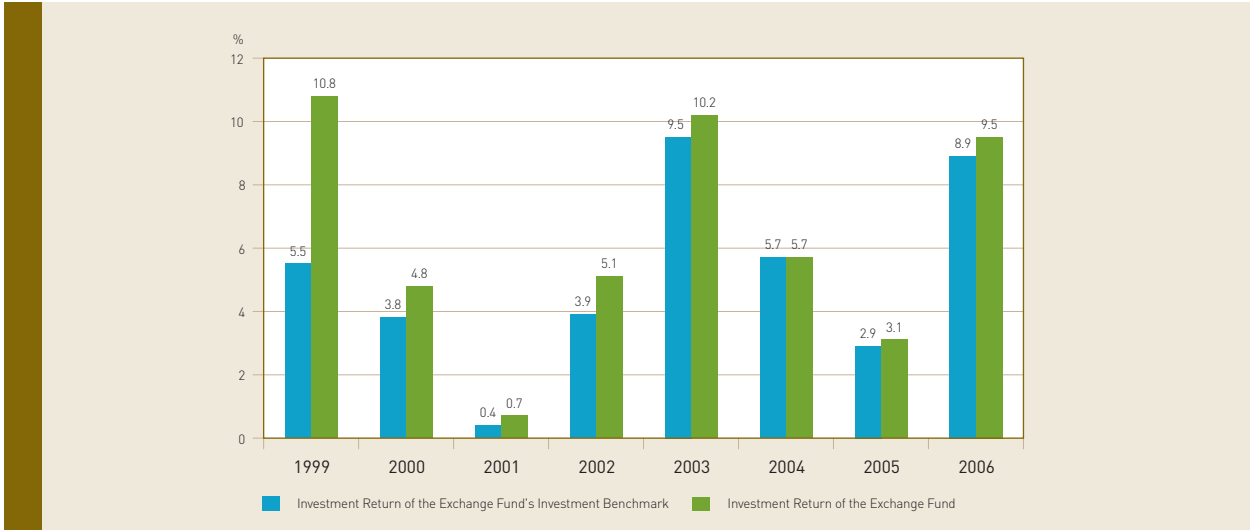
The information disclosure of the Exchange Fund is one of the most transparent among central banks and monetary authorities. Four press releases on Exchange Fund data are issued by the HKMA each month. Three of these releases disseminate monetary data in accordance with the International Monetary Fund's (IMF) Special Data Dissemination Standard. The International Reserves constitute the official currency reserves of Hong Kong and the analytical accounts of the Exchange Fund comprise specifically prescribed balance sheet data. The template on international reserves and foreign currency liquidity provides a comprehensive account of the IMF participants' foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments. The fourth release, the Exchange Fund's Abridged Balance Sheet and Currency Board Account, is made in accordance with the HKMA's policy of transparency, which helps promote public assessment and understanding of the Exchange Fund's operating results and financial position.

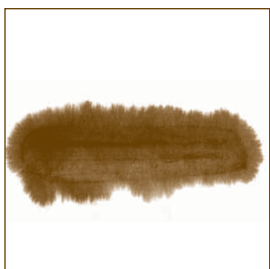
Chart 1. Investment return of the Exchange Fund (1994-2006)

Following the stringent requirements of Hong Kong’s accounting standards and market best practices, the disclosure of risk management practices for the Exchange Fund has been included in the Annual Report since 2005. The information includes qualitative descriptions and quantitative measurement of the major types of risks (such as credit risk and market risk) the Exchange Fund is exposed to, and the approaches adopted to manage these risks. The disclosure improves transparency and provides the public with useful information to assist their understanding of the management of the Exchange Fund.

 > [Press Releases](#) > [Exchange Fund](#)

Chart 2. Investment return of the Exchange Fund and the Exchange Fund’s investment benchmark (1999-2006)





Professional and Corporate Services

The Corporate Services Department, Office of the General Counsel, and Internal Audit Division provide professional and administrative support to the HKMA in carrying out its policy objectives.

THE HKMA IN THE COMMUNITY

The HKMA emphasises transparency and accessibility in its operations, and works to achieve these through

- extensive contacts with the media
- regular and special publications
- a comprehensive bilingual website
- the HKMA Information Centre
- education programmes for students and community groups
- frequent meetings with legislators
- a public enquiries service staffed nine hours a day.

These services are co-ordinated by the Corporate Development Division within the Corporate Services Department. The Division is responsible for providing media, publications and public communications services to the HKMA. It also provides translation and drafting services, and support to the Exchange Fund Advisory Committee and its Sub-Committees.

Media relations

In 2006, as in previous years, the HKMA maintained close ties with the media, one of the most important channels of communication. A number of stand-up interviews were given in 2006 in response to developments in the financial environment. During the year, the HKMA issued 276 press releases, held four press conferences and gave more than 40 written and spoken interviews. On average, the HKMA answered more than 40 press enquiries each day. One media educational briefing was organised in April to help reporters understand more about the management of the Exchange Fund.



Chief Executive Joseph Yam at a stand-up interview.

Publications

The HKMA produces a variety of publications to provide information and statistics and promote greater public understanding of its work.

The HKMA publishes its *Quarterly Bulletin* and on-line *Monthly Statistical Bulletin* as easily accessible sources of information on monetary, banking and economic issues. The June and December issues of the *Quarterly Bulletin* include the HKMA's *Half-Yearly Monetary and Financial Stability Report*, which analyses recent external and domestic influences on Hong Kong's monetary and financial systems. A new edition of the *Guide to Hong Kong Monetary and Banking Terms*, which now covers more than 200 terms, was published in November. Two new *HKMA Background Briefs* were also published during the year. Background Brief No. 3, on the mandate and governance of the HKMA, brings together the main laws and documents that determine the functions and governance arrangements of the HKMA. Background Brief No. 4 introduces to readers the financial infrastructure of Hong Kong, in the form of the clearing and settlement systems, and the HKMA's role in developing them.

The HKMA website

The HKMA website www.hkma.gov.hk provides comprehensive and accessible news and information about the HKMA for people throughout the world. All the main HKMA publications, together with a great deal of other information, are available on the website. In 2006 the website received nearly 40 million page views (Chart 1), 82% more than in 2005. Around 3,600 subscribers now receive the latest HKMA news through a daily e-mail news service.

In 2006 the HKMA launched a new feature called *Online Learning* on its website. *Online Learning* is a lively way for members of the public, especially young people, to understand how the financial and monetary systems of Hong Kong work.

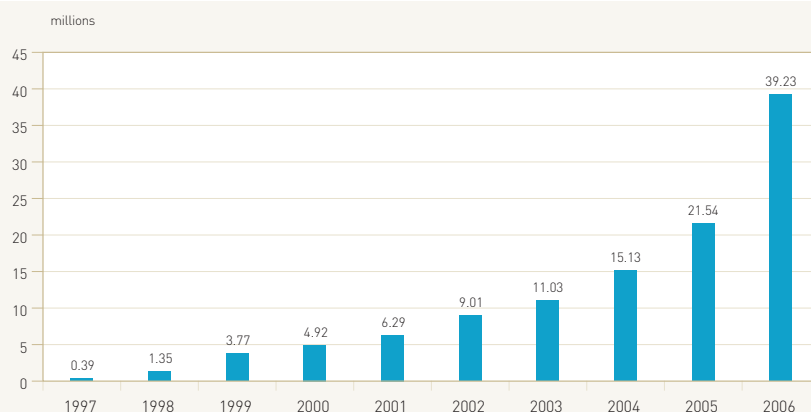
Public education programme

The HKMA Information Centre on the 55th floor of Two International Finance Centre plays an important role in the HKMA's public education programme. The Centre consists of an exhibition area and a library, and is open to the public six days a week.

Using interactive and video presentations, as well as the more traditional panels and material exhibits, the exhibition area presents a survey of the history of money and banking in Hong Kong and the key policy objectives of the HKMA. Computer programmes and interactive systems are also used to provide information about Hong Kong banknotes, Internet banking security and the payment systems of Hong Kong. Daily guided tours are organised for visitors. During the year more than 52,000 people visited the Centre and over 500 guided tours were organised for schools and other groups. More than 160,000 people have now visited the Centre since its opening in December 2003.

The Library, situated just beyond the Exhibition Area, contains a wide range of materials about Hong Kong's monetary, banking and financial affairs, and central banking topics elsewhere in the world. The main elements of the collections are publications by the HKMA and other central banks and international organisations, books and journals on monetary, banking, economics, finance and related subjects, and an electronic register of authorized institutions in Hong Kong maintained under Section 20 of the Banking Ordinance.

Chart 1. Page views of the HKMA website



The HKMA organises regular public education seminars to explain its work. In 2006, nine seminars were held for more than 3,000 students, teachers and members of the public. The Linked Exchange Rate system, Hong Kong's banknotes and the history of Hong Kong's old financial districts were the main topics of these seminars. Since the launch of the education programme in 1998, more than 33,000 students, teachers and members of the public have participated in the seminars.



Public education seminar on the Linked Exchange Rate system.



Mr Cheng Po-hung, a well-known local historian, leads a tour around the old banking and financial districts of Hong Kong.

An art competition was organised for primary school students, who were invited to create pictures of any subject using images of coins currently or previously in circulation in Hong Kong. Over 5,000 students participated in the competition and the winning drawings were displayed in the public areas of the HKMA offices at Two International Finance Centre in Central.

 > HKMA Information Centre

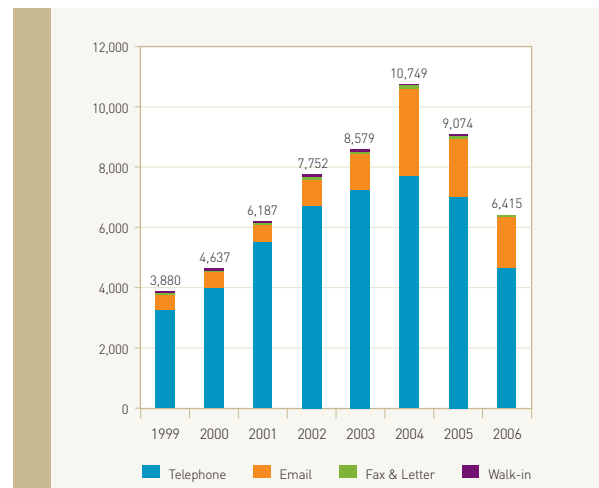


Winning entry of the art competition for primary school students. The theme of the drawing is "Celebration of peace and prosperity".

Public enquiries

The HKMA received over 6,400 public enquiries in 2006 (Chart 2). The reduction in enquiries in 2006 partly reflects the continued decline in reports about suspected fraudulent bank e-mails and websites, following the introduction of two-factor authentication, improved public education and other measures to strengthen the security of Internet banking. Most of the enquiries were received by telephone, and came from researchers, financial professionals, students and members of the public requesting statistical or other information on consumer banking issues, banking and monetary policies and other HKMA-related issues.

Chart 2. Total number of public enquiries



The HKMA is committed to delivering speedy and informed responses to all enquirers. To improve service quality in handling public enquiries, an interactive voice response system with a recording function was installed for the general telephone line of the HKMA in March. The system provides callers with pre-recorded answers to some common questions about the HKMA, such as its functions and opening hours, and directs callers with more complex questions or suggestions to staff who can help them.

HUMAN RESOURCES

The Human Resources Division provides human resources support and associated services to the HKMA.

Organisational changes

A number of organisational changes were made in 2006 to help departments respond to changing priorities. The Support Services Division was transferred from the Monetary Management and Infrastructure Department to the Strategy and Risk Department in March. The Banking Development Department was reorganised in November into three new divisions:

- the Deposit Protection Scheme Division, which supports the Deposit Protection Board and includes the Settlement Section
- the Securities Enforcement Division, which also includes the Complaints Handling Section
- the Payment Systems Oversight & Licensing Division, which includes the Licensing Section that handles Als' licensing matters.

In January 2007 the responsibilities for anti-money-laundering and counter-terrorist-financing matters of the Banking Policy Department and the Banking Supervision Department were brought together under a new division in the Banking Policy Department. The new

division also took over consumer issues previously under the Banking Development Department. The Administration Section was transferred from the Finance & Administration Division to the Corporate Development Division. The Finance & Administration Division was therefore renamed the Finance Division.

Staffing

The overall establishment of the HKMA at the end of the year was 614. The HKMA's workload has increased and become more complex in most areas of its operations. Eight new posts were added to the establishment in January 2007, representing an increase of 1.3%, to ensure that adequate resources and necessary skills are available in areas where workload has increased or where new or more complex requirements have arisen. These areas include

- setting policies for and supervising anti-money-laundering and counter-terrorist-financing activities and preparing for the evaluation of Hong Kong by the Financial Action Task Force in 2007
- addressing operational risk arising from the increasingly complex operations of Als
- increased investigation and disciplinary work in securities enforcement
- strengthening investment analysis in reserves management.

Table 1 gives a breakdown of the establishment and strength in January 2007.

 > [Careers@HKMA](#)

Table 1 Establishment and strength of the HKMA on 1 January 2007

Department	Functions	Senior staff		Others	
		Establishment	Strength	Establishment	Strength
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	6	6
Banking Development	To formulate policies for the development of the banking industry, and to facilitate settlement for transactions executed by the HKMA for the Exchange Fund.	1	1	64	63
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	37	37
Banking Supervision	To supervise day-to-day operations of authorized institutions.	1	1	154	143
Office of the General Counsel	To provide in-house legal support and advice.	1	1	15	15
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through active participation in the international central banking and financial community.	1	1	50	46
Monetary Management & Infrastructure	To maintain currency stability through monitoring of market operations and development issues and developing financial market infrastructure.	1	1	36	35
Research	To conduct research and analysis on economic and international financial market development, both in Hong Kong and in other economies.	1	1	32	31
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	53	50
Strategy & Risk	To examine and develop strategic responses to the impact on the HKMA's policies and operations of such processes as the globalisation and liberalisation of financial markets and technological change, and to ensure adequate supply of banknotes and coins.	1	1	12	11
Corporate Services	To provide support services in the form of administrative, finance, human resources, IT, and secretariat services, and to handle media and community relations.	1	1	141	134
Internal Audit	To provide audit services through assisting the management in controlling risks, monitoring compliance, and improving the efficiency of internal control systems and procedures.	0	0	8	7
Total		14	14	608	578

Remuneration policies and pay review mechanism

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

Pay for HKMA staff is reviewed annually by the Financial Secretary on the advice of EFAC and the GSC, 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, and other factors considered appropriate. The performance of individual staff members is taken into account in distributing any approved overall pay awards.

Remuneration of senior executives

The remuneration packages of the senior executives in 2006 are shown in Table 2.

Table 2. Remuneration packages of HKMA senior executives in 2006

\$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff	1	3	12
Fixed pay	6,801	4,215	2,880
Variable pay	2,550	1,267	582
Other benefits	223	508	296
Notes:			
(1) Except for annual leave accrued, the actual remuneration received by staff 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 Executive Director (ED) rank reflects staff movement during the year and includes the Chief Executive Officer of the Hong Kong Mortgage Corporation. The established number of posts at the ED level is eleven (including the CEO of the Hong Kong Mortgage Corporation): please see the organisation chart on page 31 for details.			
(3) Other benefits include provident funds or gratuity as the case may be, 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 places great emphasis on training its staff in the general and specialised skills necessary for them to do their jobs effectively. During 2006 2,600 training days were provided. These included 900 days of training in general skills common to staff of the same rank, and 1,700 days of job-specific training. Each staff member received an average of 4.32 days of training during the year.

Two senior staff participated in national studies programmes in Beijing, which were specifically organised for senior government officials of Hong Kong. Another senior staff member attended a programme on corporate leadership, jointly delivered by universities in Hong Kong and the UK. Four other staff members attended central banking courses offered by other central banks. In addition to these training opportunities, the HKMA, in co-operation with external consultants and institutions, provided training to staff at different levels to improve their leadership, language and communication skills. An in-house central banking course was also arranged for new staff.

The HKMA continued to arrange for its staff to attend job-specific training offered by other central banks, multilateral organisations and other institutions. Regular briefings and workshops conducted by in-house experts were arranged for staff in the banking departments. Topics covered in these workshops included Basel II, the Deposit Protection Scheme, anti-money-laundering measures, renminbi business and market risk. During the year, a five-week induction course was arranged for the new Assistant Managers in the banking departments.

FINANCE AND ADMINISTRATION

Finance

The Finance Section aims at achieving an efficient allocation of resources within the HKMA.

The HKMA's administration budget is prepared annually to ensure that sufficient resources are available for carrying out its functions. The budgeting process takes into account both the continuing operations of the HKMA and its strategic development set out in a three-year plan approved by the Financial Secretary on the advice of EFAC. During the budgeting 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 process requires departments to

critically assess each year the value of existing services and the cost-effectiveness of different methods of delivering them. The Finance Section scrutinises all budget requests and discusses with individual departments before submitting a consolidated draft budget for scrutiny by the senior management. The Governance Sub-Committee 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 his approval.

After the budget is approved, all expenditure under it is subject to procurement rules and guidelines and stringent financial controls. Compliance with these guidelines and procedures is subject to internal audit and is reviewed by independent auditors during the Exchange Fund annual audit.

The administrative expenditure in 2006 and the budgeted expenditure for 2007 are shown in Table 3. The difference between the 2006 and 2007 budgets arises mainly from an increase in staff costs, reflecting full-year effects of staff increases and pay adjustments in 2006, the 2007 pay adjustment, and the increase of eight posts approved for 2007 by the Financial Secretary on the advice of EFAC in areas where workload and the complexity of tasks have increased.

Table 3. Administrative expenditure (2006 and 2007 budgeted)

\$ million	2006 Budget*	2006 Actual	2007 Budget*
Staff costs	523		572
Salaries and other staff costs		479	
Retirement benefit costs		27	
Premises expenses			
Operating lease charges	4	4	4
Other premises expenses (including utility charges and management fees)	31	31	32
General operating costs			
Maintenance of office and computer equipment	35	32	29
Financial information and communication services (including trading, dealing terminals and data link charges)	31	27	32
External relations (including international meetings)	18	14	20
Professional and other services	17	15	16
Training	4	4	4
Others	5	3	5
Total HKMA administrative expenditure	668	636	714
* Includes supplementary budget and relevant provisions in project budgets for the year.			

Table 4. Additional expenses (2006 and 2007 budgeted)

\$ million	2006 Budget*	2006 Actual	2007 Budget*
Subsidy to the Hong Kong Institute for Monetary Research	10	8	12
Premises expenses of international financial organisations in Hong Kong	1	1	20
Service fees for financial infrastructure	28	28	49
* Includes supplementary budget and relevant provisions in project budgets for the year.			

There has also been an increase in expenditure to upgrade Hong Kong's financial infrastructure, in particular for the migration of the RTGS systems and the CMU from the existing proprietary platform to SWIFTNet, an open platform which makes access by users easier. 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. Expenses related to premises for international organisations in Hong Kong also increased as a result of the expansion of these international organisations in 2007, reflecting and supporting Hong Kong's status as an international financial centre. These expenses are shown in Table 4.

In addition to investment income from managing the Exchange Fund, the HKMA earns revenue mainly through licence fees paid by AIs, rental payments from tenants in Two International Finance Centre, and custodian and transaction fees from users of the Central Moneymarkets Unit. In 2007, licence fees are estimated at \$128 million and the remaining income components (excluding investment income) at \$75 million.

General administration

The HKMA continued to streamline its work flow to improve cost-effectiveness. The electronic procurement system was upgraded and detailed guidelines were given to staff to improve operational efficiency and internal controls on procurement. Regular drills were held to practise office evacuation and activation of backup facilities. Contingency plans were kept under review.

Since the adoption of the HKMA Environmental Policy in 2001, a number of green office measures have been introduced and staff awareness of environmental protection has been increasing. In 2006 31% fewer envelopes and 49% fewer paper cups were used. Electricity consumption in the HKMA's general offices¹ decreased by 3% during the year.

The HKMA supports and encourages recycling. In 2006 the HKMA donated computers and other equipment to the Computer Recycling Scheme organised by the Hong Kong Council of Social Service and the Education and Manpower Bureau. Regular campaigns were held to collect unwanted clothes, toys and other reusable items from staff for donation to charities. Waste paper and used printer cartridges were collected for recycling.

During 2006 the HKMA participated in a number of fund-raising activities including the Hong Kong Standard Chartered Marathon, the Green Power Hike, the MTR Hong Kong Race Walking, and the Run-up Two IFC Charity Race. More than 50 staff donated blood to the Hong Kong Red Cross in May. Other charity events included the Green Day, the Dress Special Day and the Skip Lunch Day organised by the Community Chest.

The HKMA Volunteer Team gave more than 330 hours of their free time in 2006 to voluntary services, including clearing refuse and plant debris in countryside, raising funds to help school students in Liannan, a mountainous area of Guangdong, and arranging events for the students of the Chak Yan Centre. The HKMA procured

office supplies from a workshop operated by people with disabilities. In recognition of the HKMA's commitment to corporate citizenship, the Hong Kong Council of Social Service awarded the Caring Organisation Logo to the HKMA in 2006/07.



HKMA volunteers and students of the Chak Yan Centre in a day camp.



Senior citizens of the Ho Kwok Pui Chun Social Centre visit the HKMA.

¹ This excludes the data centre, where the introduction of new facilities essential to the financial infrastructure of Hong Kong led to an increase of 13% in electricity consumption.

INFORMATION TECHNOLOGY

The IT Division carried out a large-scale infrastructure upgrade in 2006, covering the file-and-print system, IT security, the SWIFT platform, and the remote email system by introducing two-factor authentication. The upgrading project will continue in 2007 with the migration of the Lotus Notes workflow and email engine to a newer release. In December, an annual organisation-wide business continuity drill was conducted. The recovery times of IT systems met the targets set by the business units.

The payout system for the Deposit Protection Scheme was completed in September. During 2006, the Division continued programming and testing for the submission of new banking returns according to the requirements of Basel II, with the necessary upgrades expected to go into service in 2007. The SWIFTNet migration project continued in 2006, with completion scheduled for the first half of 2008.

OFFICE OF THE GENERAL COUNSEL

The Office of the General Counsel (OGC) advises the HKMA on the legal aspects of all of the HKMA's activities. The OGC's lawyers are involved at an early stage in the planning and implementation of the HKMA's projects, initiatives and operations.

In addition to its general operational workload, the OGC was involved in a number of projects in 2006, including the preparation of the Banking (Capital) Rules and Banking (Disclosure) Rules to implement the new capital regulatory regime in Hong Kong based upon the Basel II Capital Accord and the Deposit Protection Scheme (Asset Maintenance) Rules. All of these Rules became effective in January 2007. The OGC also advised on a number of

other projects, including the renminbi settlement system, the payment-versus-payment link between Hong Kong's US dollar RTGS system and Malaysia's ringgit RTGS system, and several bank mergers.

During the year, lawyers of the OGC participated in meetings and conferences for central bankers and their legal advisers to keep abreast of topical developments in important international financial centres. These conferences covered issues such as money laundering, financial infrastructure, resolution of banking crises, economic crime and corporate governance. OGC lawyers also took part in teleconferences with their counterparts from other central banks to clarify and resolve topics of current concern. Presentations were made by lawyers of the OGC at international forums on subjects such as central bank market intervention, economic crime and Basel II.

INTERNAL AUDIT

The Internal Audit Division was established in 1995 to assist the management in accomplishing organisational objectives by independently reviewing and evaluating the effectiveness of risk management, control and governance processes, and advising on opportunities for improvement. The role, mission and authority of the Division are defined in the Internal Audit Charter granted by the Chief Executive of the HKMA. The Charter is available at the HKMA website. The Division reports directly to the Chief Executive of the HKMA and the EFAC Audit Sub-Committee.

The Division continued to operate independently and effectively in 2006. Co-ordinated by the Division, line management of all business units updated their risk assessment reports, which identify and assess risks and

corresponding controls in their operations. Based on the risk profiles of individual business units, the Division prepared an audit plan covering all the significant risks. The Division also analysed the results of the assessments to facilitate review by the Risk Committee.

Internal audit assignments carried out by the Division covered monetary operations, reserves management, monitoring and supervision of clearing systems, settlement operations, budgetary control, financial management reporting, operations and security of the data centre, security and contingency arrangements of critical IT systems and the business continuity plans of business units. The Division also advised on IT system development projects and performed ad hoc reviews at the request of the senior management. The results of the audits conducted in 2006 were satisfactory. Recommendations for improvement put forward by the Division were accepted and implemented by the management.

The Division attaches great importance to keeping abreast of developments in internal auditing standards and the practices adopted by other central banks. During 2006 staff of the Division attended an international conference of heads of internal audit of central banks organised by the Bank for International Settlements. They also visited and received internal auditors of other central banks to exchange views and share experience in risk management and internal auditing. Training courses and seminars on risk management, audit techniques, management and language skills were arranged for staff of the Division.

 > Internal Audit

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 measurement 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, as well as to identify potential or emerging risks and devise mitigating strategies. One of the areas on which the Committee focused in 2006 was business continuity planning for a possible outbreak of avian flu, not only for the HKMA but also the financial sectors for which it is responsible. The Committee also considered ways to strengthen the corporate business continuity plan of the HKMA and refinements to the Risk Assessment Methodology to facilitate a more efficient self-assessment of risks.

The Exchange Fund

- Report of the Director of Audit
- Exchange Fund – Income and Expenditure Account
- Exchange Fund – Balance Sheet
- Exchange Fund – Statement of Changes in Equity
- Exchange Fund – Cash Flow Statement
- Exchange Fund – Notes on the Accounts

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 114 to 185, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2006, and their income and expenditure accounts, statements of changes in equity and cash flow statements for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Monetary Authority's responsibility for the financial statements

The Monetary Authority is responsible for the preparation and the true and fair presentation of these financial statements 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. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

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 as to 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 and true and fair presentation of the financial statements 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

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 2006 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

22 March 2007

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

Exchange Fund - Income and Expenditure Account

for the year ended 31 December 2006

		Group		Fund	
		2006	2005	2006	2005
(Expressed in millions of Hong Kong dollars)	Notes		(restated)		
INCOME					
Interest income		43,483	31,496	41,184	29,719
Dividend income		6,162	5,165	6,429	5,430
Net realised and revaluation gains		38,799	22,173	38,806	22,182
Net exchange gains/(losses)		17,360	(19,468)	17,338	(19,474)
Investment income	4(a)	105,804	39,366	103,757	37,857
Bank licence fees		132	129	132	129
Other income		277	269	64	36
TOTAL INCOME		106,213	39,764	103,953	38,022
EXPENDITURE					
Interest expense	4(b)	(38,996)	(17,137)	(37,421)	(16,026)
Operating expenses	4(c)	(1,986)	(1,628)	(1,810)	(1,463)
Note and coin expenses	4(d)	(160)	(208)	(160)	(208)
Write back of impairment losses on loans		8	19	-	-
TOTAL EXPENDITURE		(41,134)	(18,954)	(39,391)	(17,697)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE					
		65,079	20,810	64,562	20,325
Share of profit of associate, net of tax		8	3	-	-
SURPLUS BEFORE TAXATION					
		65,087	20,813	64,562	20,325
Income tax		(86)	(100)	-	-
SURPLUS FOR THE YEAR					
ATTRIBUTABLE TO:					
Owner of the Fund		64,987	20,690	64,562	20,325
Minority interests		14	23	-	-
		65,001	20,713	64,562	20,325

The notes on pages 119 to 185 form part of these accounts.

Exchange Fund - Balance Sheet

as at 31 December 2006

		Group		Fund	
(Expressed in millions of Hong Kong dollars)	Notes	2006	2005 (restated)	2006	2005
ASSETS					
Cash and money at call	6	19,726	15,937	19,661	15,887
Placements with banks and other financial institutions	7	44,670	75,667	42,766	73,120
Derivative financial instruments	8(a)	1,490	1,953	1,227	1,865
Financial assets designated at fair value through profit or loss	9	1,088,192	953,145	1,088,192	953,145
Available-for-sale securities	10	5,107	2,483	493	493
Held-to-maturity securities	11	4,753	4,585	–	–
Loan portfolio	12	32,394	33,549	–	–
Gold	13	330	266	330	266
Other assets	14	18,926	17,023	17,949	16,149
Investments in subsidiaries	15	–	–	2,145	2,145
Interest in associate	16	35	26	–	–
Property, plant and equipment	17	853	888	611	625
Operating land lease prepayment	18	2,997	3,071	2,997	3,071
Intangible assets	19	22	33	22	33
TOTAL ASSETS		1,219,495	1,108,626	1,176,393	1,066,799
LIABILITIES AND EQUITY					
Certificates of Indebtedness	20	156,926	148,406	156,926	148,406
Government-issued currency notes and coins in circulation	20	6,842	6,671	6,842	6,671
Balance of the banking system	21	2,035	1,561	2,035	1,561
Derivative financial instruments	8(a)	735	869	572	525
Trading liabilities	22	2,096	7,412	2,096	7,412
Placements by banks and other financial institutions	23	7,572	25,712	7,572	25,712
Placements by other Hong Kong Special Administrative Region government funds	24	324,530	297,086	324,530	297,086
Placements by Hong Kong statutory bodies		26	–	26	–
Exchange Fund Bills and Notes issued	25	129,139	118,134	129,139	118,134
Other debt securities issued	26	28,910	27,991	–	–
Mortgage-backed securities issued	27	5,341	5,145	–	–
Other liabilities	28	44,231	23,541	38,947	18,146
Total liabilities		708,383	662,528	668,685	623,653
Accumulated surplus	29	510,813	445,826	507,708	443,146
Available-for-sale securities revaluation reserve	29	125	94	–	–
Total equity attributable to owner of the Fund		510,938	445,920	507,708	443,146
Minority interests	29	174	178	–	–
Total equity		511,112	446,098	507,708	443,146
TOTAL LIABILITIES AND EQUITY		1,219,495	1,108,626	1,176,393	1,066,799

Joseph Yam

Monetary Authority

22 March 2007

The notes on pages 119 to 185 form part of these accounts.

Exchange Fund - Statement of Changes in Equity

for the year ended 31 December 2006

		Group			2005 (restated)			Fund	
		2006						2006	2005
(Expressed in millions of Hong Kong dollars)	NOTES	Attributable to owner of the Fund	Minority interests	Total equity	Attributable to owner of the Fund	Minority interests	Total equity	Attributable to owner of the Fund	
Total equity at 1 January									
As previously reported		445,922	178	446,100	425,139	167	425,306	443,146	422,821
Prior year adjustment to accumulated surplus arising from changes in accounting policy under HKAS 27	29	(2)	-	(2)	(3)	-	(3)	-	-
As restated	29	445,920	178	446,098	425,136	167	425,303	443,146	422,821
Fair value gains on available-for-sale securities									
Net gains recognised directly in equity	29	31	-	31	87	-	87	-	-
Net losses transferred to income and expenditure account on disposal	29	-	-	-	7	-	7	-	-
		31	-	31	94	-	94	-	-
Surplus for the year									
As previously reported					20,689	23	20,712		
Prior year adjustment arising from changes in accounting policy under HKAS 27	3.1.1				1	-	1		
Surplus for the year (2005: as restated)	29	64,987	14	65,001	20,690	23	20,713	64,562	20,325
Dividends paid to minority interests	29	-	(18)	(18)	-	(12)	(12)	-	-
Total equity at 31 December	29	510,938	174	511,112	445,920	178	446,098	507,708	443,146

The notes on pages 119 to 185 form part of these accounts.

Exchange Fund - Cash Flow Statement

for the year ended 31 December 2006

		Group		Fund	
		2006	2005	2006	2005
(Expressed in millions of Hong Kong dollars)	Notes		(restated)		
Cash flows from operating activities					
Surplus before share of profit of associate		65,079	20,810	64,562	20,325
Adjustments for:					
Interest income	4(a)	(43,483)	(31,496)	(41,184)	(29,719)
Dividend income	4(a)	(6,162)	(5,165)	(6,429)	(5,430)
Net (gains)/losses on available-for-sale securities	4(a)	(19)	7	-	-
Interest expense	4(b)	38,996	17,137	37,421	16,026
Depreciation and amortisation	4(c)	149	147	117	116
Elimination of exchange differences and other non-cash items		(1,695)	1,989	(1,587)	2,068
Interest received		41,755	31,666	39,705	29,889
Interest paid		(20,090)	(21,516)	(18,606)	(20,424)
Dividends received		6,149	5,156	6,133	5,156
Income tax paid		(63)	(161)	-	-
		80,616	18,574	80,132	18,007
Change in fair value of derivatives and other debt securities issued		727	(2,310)	683	(2,324)
Change in placements with banks and other financial institutions		(1,723)	33	(1,535)	3
Change in financial assets designated at fair value through profit or loss		(225,220)	40,740	(225,220)	40,740
Change in loan portfolio		1,180	7,254	-	-
Change in gold		(64)	(38)	(64)	(38)
Change in other assets		(168)	(5,361)	(298)	(5,329)
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		8,691	2,487	8,691	2,487
Change in balance of the banking system		474	(14,228)	474	(14,228)
Change in trading liabilities		(5,316)	5,820	(5,316)	5,820
Change in placements by banks and other financial institutions		(18,140)	(13,362)	(18,140)	(13,362)
Change in placements by other Hong Kong Special Administrative Region government funds		27,444	16,995	27,444	16,995
Change in placements by Hong Kong statutory bodies		26	-	26	-
Change in Exchange Fund Bills and Notes issued		11,005	(4,951)	11,005	(4,951)
Change in other liabilities		1,763	647	1,989	734
Net cash from/(used in) operating activities		(118,705)	52,300	(120,129)	44,554

Exchange Fund - Cash Flow Statement (cont.)

for the year ended 31 December 2006

		Group		Fund	
		2006	2005 (restated)	2006	2005
(Expressed in millions of Hong Kong dollars)	Notes				
Cash flows from investing activities					
Proceeds from sale or redemption of available-for-sale securities		18,602	2,217	–	–
Purchase of available-for-sale securities		(21,051)	(4,287)	–	(193)
Proceeds from redemption of held-to-maturity securities		229	5,644	–	–
Purchase of held-to-maturity securities		(397)	(6,105)	–	–
Purchase of property, plant and equipment and intangible assets		(29)	(69)	(18)	(25)
Dividends received from subsidiaries		–	–	272	265
Net cash from/(used in) investing activities		(2,646)	(2,600)	254	47
Cash flows from financing activities					
Proceeds from issue of other debt securities		13,202	5,091	–	–
Redemption of other debt securities issued		(12,699)	(12,348)	–	–
Proceeds from issue of mortgage-backed securities		2,000	980	–	–
Redemption of mortgage-backed securities issued		(1,830)	(1,671)	–	–
Dividends paid to minority shareholders		(18)	(12)	–	–
Net cash from/(used in) financing activities		655	(7,960)	–	–
Net increase/(decrease) in cash and cash equivalents		(120,696)	41,740	(119,875)	44,601
Cash and cash equivalents at 1 January		218,541	178,866	215,953	173,420
Effect of foreign exchange rate changes		1,592	(2,065)	1,587	(2,068)
Cash and cash equivalents at 31 December	30	99,437	218,541	97,665	215,953

The notes on pages 119 to 185 form part of these accounts.

Exchange Fund - Notes on the Accounts

(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. 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 consolidated financial statements of the Group comprise the Fund and its subsidiaries (together referred to as the "Group") and the Group's interest in an associate. The principal activities of the subsidiaries and the associate are shown in notes 15 and 16.

The assets of the Fund are managed as two distinct portfolios: the Backing Portfolio and the Investment Portfolio. The assets of the Backing Portfolio fully match the Monetary Base, under Hong Kong's Currency Board system. The balance of the Fund's assets constitutes the Investment Portfolio. Segment information is set out in note 31.

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 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.

2.2 Basis of preparation of the financial statements

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 through profit or loss (note 2.5.2.2);
- available-for-sale securities (note 2.5.2.5); and
- gold (note 2.10).

Exchange Fund - Notes on the Accounts (cont.)

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

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 expenses. 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 37 contains information about the assumptions and risk factors relating to fair value estimation of financial instruments. There are no critical accounting judgements involved in the application of the Group's accounting policies.

2.3 Subsidiaries

A subsidiary is an entity controlled by the Group. Controls exist 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.

Minority interests represent the portion of the net assets of subsidiaries attributable to equity interests that are not owned by the Fund, whether directly or indirectly through subsidiaries, 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. Minority interests are presented in the Group balance sheet within equity, separately from equity attributable to the owner of the Fund. Minority interests in the results of the Group are presented on the face of the Group income and expenditure account as an allocation of the surplus for the year between minority interests and the owner of the Fund.

In the Fund balance sheet, its investments in subsidiaries are stated at cost less impairment losses, if any (note 2.14).

Exchange Fund - Notes on the Accounts (cont.)

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

2.4 Associate

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

An investment in an associate is accounted for in the Group financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The Group income and expenditure account includes the Group's share of the post-tax results of the associate for the year.

Unrealised profits and losses resulting from transactions between the Group and its associate are eliminated to the extent of the Group's interest in the associate.

In the Fund balance sheet, its investment in an associate is stated at cost less impairment losses, if any (note 2.14).

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 through profit or loss, 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 value, which normally will 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 asset or the issue of the financial liability. Transaction costs on trading financial instruments and financial assets and financial liabilities designated at fair value through profit or loss 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 designated at fair value through profit or loss, 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. From this date, any gains and losses arising from changes in fair value are recorded. Other financial assets and financial liabilities are recognised using settlement date accounting.

Exchange Fund - Notes on the Accounts (cont.)

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

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.

2.5.2.2 Financial assets and financial liabilities designated at fair value through profit or loss

Financial assets and financial liabilities designated at fair value through profit or loss 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 Fund’s 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 through profit or loss or as available-for-sale. This category includes placements with banks and other financial institutions, cash and money at call, and loan portfolios purchased by 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 through profit or loss or as available-for-sale; and (b) those that meet the definition of loans and receivables.

Exchange Fund - Notes on the Accounts (cont.)

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

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.

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

The investment by the Fund in shares of the Bank for International Settlements is held on a long term basis for strategic purposes. 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, together with the accumulated fair value adjustments 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 through profit or loss.

Other financial liabilities with a fixed maturity are measured at amortised cost using the effective interest method. These include placements by banks and other financial institutions, placements by other Hong Kong Special Administrative Region (HKSAR) government funds with fixed maturity, placements by Hong Kong statutory bodies, mortgage-backed securities and other debt securities (other than those which contain embedded derivatives) issued by the HKMC.

Other financial liabilities repayable on demand are stated at the principal amount payable. These include Certificates of Indebtedness and government-issued currency notes and coins in circulation (note 2.5.2.7), placements by other HKSAR government funds which are repayable on demand and the balance of the banking system.

Exchange Fund - Notes on the Accounts (cont.)

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

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 dollar equivalent of the US dollars required for their redemption at the exchange rate ruling at the balance sheet date.

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.

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.

Exchange Fund - Notes on the Accounts (cont.)

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

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

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 set off the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability 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.

Embedded derivatives are 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).

The early call options embedded in the debt securities issued by the HKMC are not separated as the entire hybrid (combined) contracts are accounted for as financial liabilities designated at fair value through profit or loss (note 2.5.2.2).

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 their original measurement principles. 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.

Exchange Fund - Notes on the Accounts (cont.)

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

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 their original measurement principles. Where cash collateral is received, a liability is recorded in respect of the cash received in "placements by banks and other financial institutions".

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 adopts hedge accounting for derivatives used in hedges of exposures to changes in fair values of certain fixed rate debt securities issued by the HKMC (fair value hedges). The Group assesses and documents whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values of hedged items attributable to the hedged risks both at hedge inception and on an ongoing basis. The Group discontinues prospectively hedge accounting when (a) the hedging instrument expires or is sold, terminated or exercised; (b) the hedge no longer meets the criteria for hedge accounting; or (c) the Group revokes the designation.

Derivatives that qualify 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 hedging instrument expires or is sold, terminated or exercised, the hedge no longer meets the criteria for hedge accounting, or the Group revokes designation of the hedge relationship, any adjustment up to that point, to a hedged item for which the effective interest method is used, is amortised to the income and expenditure account as part of the recalculated effective interest rate of the item over its remaining life.

2.9 Impairment of financial assets

The carrying amount 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.

Exchange Fund - Notes on the Accounts (cont.)

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

For available-for-sale securities carried at fair value, the cumulative loss - measured as the difference between the acquisition cost 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 directly in equity.

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 2.14):

- a building held for own use situated on freehold land;
- a building held for own use situated on leasehold land, where the fair value of the leasehold interest in the land and building can be measured separately at the inception of the lease. The land element is treated as an operating land lease prepayment (note 2.12); and
- plant and equipment, including plant, machinery, furniture, fixtures, equipment, motor vehicles and personal computers.

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 the estimated useful lives as follows:

- Freehold land is not depreciated.
- Building situated on freehold land 39 years
- Buildings situated on leasehold land are depreciated over the shorter of the unexpired term of lease and their estimated useful lives.
- Plant and equipment 2-15 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.

Exchange Fund - Notes on the Accounts (cont.)

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

2.12 Operating land lease prepayment

Operating land lease prepayment is the land element of the payment for a building held for own use situated on leasehold land, the fair value of which could be measured separately from the fair value of the building at the inception of the lease. The valuation was carried out by an independent professional valuer who estimated the value of the building element using the "net replacement cost" method and took the residual figure as the value of the land element. The land element, accounted for as an operating lease, is stated in the balance sheet at cost less accumulated amortisation and any impairment losses (note 2.14). The land element is amortised on a straight-line basis over the unexpired term of the lease.

2.13 Intangible assets

Intangible assets include acquired computer software licences and capitalised development costs of computer software programmes. Expenditure on development of computer software programmes is capitalised if the programmes are technically and commercially feasible and the Group has sufficient resources and intention to complete development. The expenditure capitalised includes the direct labour and costs of materials. Intangible assets are stated at cost less accumulated amortisation and any impairment losses (note 2.14).

Amortisation of intangible assets is charged to the income and expenditure account on a straight-line basis over the assets' estimated useful lives of 3 to 5 years. Both the period and method of amortisation are reviewed annually.

2.14 Impairment of other assets

The carrying amount of other assets, including investments in subsidiaries, investment in associate, property, plant and equipment and intangible assets, 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 net selling price and value in use.

2.15 Cash equivalents

Cash equivalents include 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.

2.16 Revenue and expenditure recognition

2.16.1 Interest income and expense

Interest on the majority of the placements by other HKSAR government funds is payable at rates determined by reference to the investment income of the Fund. Interest on these placements is recognised monthly in the income and expenditure account on an accrual basis, based on the investment income of the Fund for the month.

Exchange Fund - Notes on the Accounts (cont.)

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

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 instruments (for example, prepayment options) 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.

2.16.2 Net realised and revaluation gains

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 through profit or loss are recognised as revaluation gains or losses in the income and expenditure account.

2.16.3 Dividend and other income

Dividend income from listed equity securities is recognised 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 and are accounted for in the period when the fees become receivable.

Other income includes income from the sale of withdrawn coins and Central Moneymarkets Unit fee income. Other income is accounted for in the period when it becomes receivable.

2.16.4 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.

Exchange Fund - Notes on the Accounts (cont.)

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

2.16.5 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.

2.16.6 Income tax

The Fund is exempt from 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 asset can be utilised. Deferred tax liabilities are provided in full.

2.17 Foreign currency translation

Foreign currency transactions during the year are translated into Hong Kong dollars at the exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the exchange rates ruling 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 exchange rates ruling 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 exchange rates ruling at the dates when the fair value was determined.

All exchange 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 through profit or loss or on trading financial instruments, the majority of the exchange gains/(losses) relate to these two categories of financial instruments.

2.18 Related parties

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

- (i) 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;
- (ii) the Group and the party are subject to common control;
- (iii) the party is an associate of the Group;

Exchange Fund - Notes on the Accounts (cont.)

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

- (iv) 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;
- (v) the party is a close family member of a party referred to in (i) or is an entity under the control, joint control or significant influence of such individuals; or
- (vi) 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.

2.19 Segment reporting

The activities of the Group comprise the following business segments:

- Management of funds under the Currency Board Operations;
- Management of funds representing the general reserve assets of the Fund; and
- Maintaining the stability and integrity of monetary and financial systems of Hong Kong, including banking supervision, monetary management and the activities of the subsidiaries.

Details are set out in note 31. There is no disclosure of geographic segments as the Group operates predominantly in Hong Kong. In line with the normal practice of central banking institutions, no further breakdown of the Group's investments by currencies or geographic markets is disclosed.

3 CHANGES IN ACCOUNTING POLICIES

The HKICPA has issued certain new and revised HKFRSs that are effective for the current accounting period. Other than HKAS 27 (revised), Consolidated and Separate Financial Statements, there were no significant changes in accounting policies for the current and prior accounting periods resulting from the adoption of these HKFRSs. The Group has not applied any HKFRS that is not yet effective for the current accounting period (see note 40).

With effect from 1 January 2006, in order to comply with HKAS 27 (revised), the Group has changed its accounting policy relating to the consolidation of Special Purpose Entities (SPEs). Under the new policy, two SPEs established by the HKMC in relation to its mortgage-backed securities programme are consolidated in the Group financial statements. These SPEs were not previously consolidated under the previous HKAS 27 as they did not meet the legal definition of a subsidiary. However, following an amendment of the Hong Kong Companies Ordinance, which came into effect for the accounting period beginning 1 January 2006, these SPEs are deemed to be subsidiary undertakings of the HKMC.

In accordance with HKAS 27 (revised), the change in accounting policy has been applied retrospectively by restating opening balances at 1 January 2005 and 2006, with consequential adjustments to comparatives for the year ended 31 December 2005. The adjustments for each financial statement line item affected for the years ended 31 December 2005 and 2006 are set out in notes 3.1 and 3.2.

Exchange Fund - Notes on the Accounts (cont.)

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

3.1 Restatement of prior period and opening balances

The following tables disclose the adjustments that have been made to each of the line items in the Group income and expenditure account and balance sheet as previously reported for the year ended 31 December 2005. The effects of the change in accounting policy on equity at 1 January 2005 and 2006 are disclosed in note 29.

3.1.1 Effect on the Group income and expenditure account for the year ended 31 December 2005

	2005 (as previously reported)	Group Effect of new policy (increase/ (decrease) in surplus for the year)	2005 (restated)
		Consolidation of SPEs	
INCOME			
Interest income	31,307	189	31,496
Dividend income	5,165	–	5,165
Net realised and revaluation gains	22,173	–	22,173
Net exchange losses	(19,468)	–	(19,468)
Bank licence fees	129	–	129
Other income	308	(39)	269
TOTAL INCOME	39,614	150	39,764
EXPENDITURE			
Interest expense	(16,990)	(147)	(17,137)
Operating expenses	(1,626)	(2)	(1,628)
Note and coin expenses	(208)	–	(208)
Write back of impairment losses on loans	19	–	19
TOTAL EXPENDITURE	(18,805)	(149)	(18,954)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE	20,809	1	20,810
Share of profit of associate	3	–	3
SURPLUS BEFORE TAXATION	20,812	1	20,813
Income tax	(100)	–	(100)
SURPLUS FOR THE YEAR	20,712	1	20,713
ATTRIBUTABLE TO:			
Owner of the Fund	20,689	1	20,690
Minority interests	23	–	23
	20,712	1	20,713

Exchange Fund - Notes on the Accounts (cont.)

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

3.1.2 Effect on the Group balance sheet at 31 December 2005

	2005 (as previously reported)	Group Effect of new policy (increase/ (decrease) in total assets and total liabilities)	2005 (restated)
		Consolidation of SPEs	
ASSETS			
Cash and money at call	15,937	–	15,937
Placements with banks and other financial institutions	75,648	19	75,667
Derivative financial instruments	1,950	3	1,953
Financial assets designated at fair value through profit or loss	953,145	–	953,145
Available-for-sale securities	2,483	–	2,483
Held-to-maturity securities	4,605	(20)	4,585
Loan portfolio	29,476	4,073	33,549
Gold	266	–	266
Other assets	17,015	8	17,023
Investment in associate	26	–	26
Property, plant and equipment	888	–	888
Operating land lease prepayment	3,071	–	3,071
Intangible assets	33	–	33
TOTAL ASSETS	1,104,543	4,083	1,108,626
LIABILITIES AND EQUITY			
Certificates of Indebtedness	148,406	–	148,406
Government-issued currency notes and coins in circulation	6,671	–	6,671
Balance of the banking system	1,561	–	1,561
Derivative financial instruments	834	35	869
Trading liabilities	7,412	–	7,412
Placements by banks and other financial institutions	25,712	–	25,712
Placements by other HKSAR government funds	297,086	–	297,086
Exchange Fund Bills and Notes issued	118,134	–	118,134
Other debt securities issued	27,991	–	27,991
Mortgage-backed securities issued	–	5,145	5,145
Other liabilities	24,636	(1,095)	23,541
Total liabilities	658,443	4,085	662,528
Accumulated surplus	445,828	(2)	445,826
Available-for-sale securities revaluation reserve	94	–	94
Total equity attributable to owner of the Fund	445,922	(2)	445,920
Minority interests	178	–	178
Total equity	446,100	(2)	446,098
TOTAL LIABILITIES AND EQUITY	1,104,543	4,083	1,108,626

Exchange Fund - Notes on the Accounts (cont.)

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

3.2 Estimated effect of changes in accounting policies on the current year

The following tables provide estimates of the extent to which each of the line items in the Group income and expenditure account and balance sheet for the year ended 31 December 2006 is higher or lower than it would have been had the previous accounting policy still been applied in the year.

3.2.1 Effect on the Group income and expenditure account for the year ended 31 December 2006

	Group
	Effect of new policy (increase/(decrease) in surplus for the year)
	Consolidation of SPEs
INCOME	
Interest income	251
Other income	(42)
TOTAL INCOME	209
EXPENDITURE	
Interest expense	(208)
Write back of impairment losses on loans	1
TOTAL EXPENDITURE	(207)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE	2
Share of profit of associate	–
SURPLUS BEFORE TAXATION	2
Income tax	–
SURPLUS FOR THE YEAR	2
ATTRIBUTABLE TO:	
Owner of the Fund	2
Minority interests	–
	2

Exchange Fund - Notes on the Accounts (cont.)

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

3.2.2 Effect on the Group balance sheet at 31 December 2006

	Group
	Effect of new policy (increase/(decrease) in total assets and total liabilities)
	Consolidation of SPEs
ASSETS	
Placements with banks and other financial institutions	384
Derivative financial instruments	9
Held-to-maturity securities	(20)
Loan portfolio	3,794
Other assets	(10)
TOTAL ASSETS	4,157
LIABILITIES AND EQUITY	
Derivative financial instruments	15
Mortgage-backed securities issued	5,341
Other liabilities	(1,197)
Total liabilities	4,159
Accumulated surplus	(2)
Available-for-sale securities revaluation reserve	–
Total equity attributable to owner of the Fund	(2)
Minority interests	–
Total equity	(2)
TOTAL LIABILITIES AND EQUITY	4,157

Exchange Fund - Notes on the Accounts (cont.)

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

4. INCOME AND EXPENDITURE

(a) Investment income

	Group		Fund	
	2006	2005 (restated)	2006	2005
Interest income				
– from derivative financial instruments	189	374	189	374
– from financial assets designated at fair value through profit or loss	35,059	24,782	35,059	24,782
– from other financial assets	8,235	6,340	5,936	4,563
	43,483	31,496	41,184	29,719
Dividend income				
– from financial assets designated at fair value through profit or loss	6,134	5,157	6,134	5,157
– from other financial assets	28	8	12	8
– from subsidiaries	–	–	283	265
	6,162	5,165	6,429	5,430
Net realised and revaluation gains/(losses)				
– on derivative financial instruments	1,875	411	1,500	1,484
– on financial assets and financial liabilities designated at fair value through profit or loss	36,905	21,769	37,306	20,698
– on available-for-sale securities	19	(7)	–	–
	38,799	22,173	38,806	22,182
Net exchange gains/(losses)	17,360	(19,468)	17,338	(19,474)
TOTAL INVESTMENT INCOME	105,804	39,366	103,757	37,857

Exchange Fund - Notes on the Accounts (cont.)

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

(b) Interest expense

	Group		Fund	
	2006	2005 (restated)	2006	2005
Interest expense on derivative financial instruments	3	–	3	–
Interest expense on Exchange Fund Bills and Notes and other debt securities issued designated at fair value through profit or loss and trading liabilities	5,119	3,273	5,033	3,182
Interest expense on other financial liabilities	33,874	13,864	32,385	12,844
TOTAL	38,996	17,137	37,421	16,026
Comprises:				
Interest on placements by other HKSAR government funds				
With interest at rates determined by reference to the investment income of the Fund	28,936	10,060	28,936	10,060
With interest at market-based rates	203	122	203	122
Interest on Exchange Fund Bills and Notes issued	4,934	3,061	4,934	3,061
Other interest expense	4,923	3,894	3,348	2,783
	38,996	17,137	37,421	16,026

Exchange Fund - Notes on the Accounts (cont.)

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

(c) Operating expenses

	Group		Fund	
	2006	2005 (restated)	2006	2005
Staff costs				
Salaries and other staff costs	582	554	479	449
Retirement benefit costs	33	31	27	25
Premises and equipment expenses				
Depreciation and amortisation	149	147	117	116
Rental expense under operating leases	4	5	4	4
Other premises expenses	38	37	32	31
General operating costs				
Maintenance of office and computer equipment	37	33	32	27
Financial information and communication services	32	33	27	28
External relations	15	13	14	12
Service fees for financial infrastructure	28	10	28	10
Other professional services	27	22	15	13
Training	5	5	4	4
Others	12	3	11	13
Investment management and custodian fees				
Management and custodian fees	699	489	699	489
Transaction costs	172	143	168	139
Withholding tax	146	99	146	99
Others	7	4	7	4
TOTAL	1,986	1,628	1,810	1,463

Exchange Fund - Notes on the Accounts (cont.)

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

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

	Group	
	2006	2005
Fixed pay	50.4	47.8
Variable pay	12.8	11.9
Other benefits	5.0	4.4
	68.2	64.1

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

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

	Group	
HK\$	2006	2005
500,000 or below	1	1
1,000,001 to 1,500,000	–	2
2,500,001 to 3,000,000	–	1
3,000,001 to 3,500,000	4	4
3,500,001 to 4,000,000	6	3
4,000,001 to 4,500,000	1	3
5,000,001 to 5,500,000	–	1
5,500,001 to 6,000,000	1	–
6,000,001 to 6,500,000	2	1
9,500,001 to 10,000,000	1	1
	16	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 on the Accounts (cont.)

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

5 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Group - 2006								
			Trading financial instruments (including hedging instruments)	Financial assets and financial liabilities designated at fair value through profit or loss	Loans and receivables	Held-to- maturity securities	Available- for-sale securities	Other financial liabilities
	Notes	Total						
Cash and money at call	6	19,726	-	-	19,726	-	-	-
Placements with banks and other financial institutions	7	44,670	-	-	44,670	-	-	-
Derivative financial instruments	8(a)	1,490	1,490	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9	1,088,192	-	1,088,192	-	-	-	-
Available-for-sale securities	10	5,107	-	-	-	-	5,107	-
Held-to-maturity securities	11	4,753	-	-	-	4,753	-	-
Loan portfolio	12	32,394	-	-	32,394	-	-	-
Other assets	14	18,926	-	-	18,926	-	-	-
FINANCIAL ASSETS		1,215,258	1,490	1,088,192	115,716	4,753	5,107	-
Certificates of Indebtedness	20	156,926	-	-	-	-	-	156,926
Government-issued currency notes and coins in circulation	20	6,842	-	-	-	-	-	6,842
Balance of the banking system	21	2,035	-	-	-	-	-	2,035
Derivative financial instruments	8(a)	735	735	-	-	-	-	-
Trading liabilities	22	2,096	2,096	-	-	-	-	-
Placements by banks and other financial institutions	23	7,572	-	-	-	-	-	7,572
Placements by other HKSAR government funds	24	324,530	-	-	-	-	-	324,530
Placements by Hong Kong statutory bodies		26	-	-	-	-	-	26
Exchange Fund Bills and Notes issued	25	129,139	-	129,139	-	-	-	-
Other debt securities issued	26	28,910	-	2,981	-	-	-	25,929
Mortgage-backed securities issued	27	5,341	-	-	-	-	-	5,341
Other liabilities	28	44,231	-	-	-	-	-	44,231
FINANCIAL LIABILITIES		708,383	2,831	132,120	-	-	-	573,432

Exchange Fund - Notes on the Accounts (cont.)

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

					Group – 2005 (restated)			
	Notes	Total	Trading financial instruments (including hedging instruments)	Financial assets and financial liabilities designated at fair value through profit or loss	Loans and receivables	Held-to- maturity securities	Available- for-sale securities	Other financial liabilities
Cash and money at call	6	15,937	–	–	15,937	–	–	–
Placements with banks and other financial institutions	7	75,667	–	–	75,667	–	–	–
Derivative financial instruments	8(a)	1,953	1,953	–	–	–	–	–
Financial assets designated at fair value through profit or loss	9	953,145	–	953,145	–	–	–	–
Available-for-sale securities	10	2,483	–	–	–	–	2,483	–
Held-to-maturity securities	11	4,585	–	–	–	4,585	–	–
Loan portfolio	12	33,549	–	–	33,549	–	–	–
Other assets	14	17,023	–	–	17,023	–	–	–
FINANCIAL ASSETS		1,104,342	1,953	953,145	142,176	4,585	2,483	–
Certificates of Indebtedness	20	148,406	–	–	–	–	–	148,406
Government-issued currency notes and coins in circulation	20	6,671	–	–	–	–	–	6,671
Balance of the banking system	21	1,561	–	–	–	–	–	1,561
Derivative financial instruments	8(a)	869	869	–	–	–	–	–
Trading liabilities	22	7,412	7,412	–	–	–	–	–
Placements by banks and other financial institutions	23	25,712	–	–	–	–	–	25,712
Placements by other HKSAR government funds	24	297,086	–	–	–	–	–	297,086
Exchange Fund Bills and Notes issued	25	118,134	–	118,134	–	–	–	–
Other debt securities issued	26	27,991	–	2,600	–	–	–	25,391
Mortgage-backed securities issued	27	5,145	–	–	–	–	–	5,145
Other liabilities	28	23,541	–	–	–	–	–	23,541
FINANCIAL LIABILITIES		662,528	8,281	120,734	–	–	–	533,513

Exchange Fund - Notes on the Accounts (cont.)

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

Fund – 2006								
			Financial assets and financial liabilities designated Trading financial instruments	at fair value through profit or loss	Loans and receivables	Held-to- maturity securities	Available- for-sale securities	Other financial liabilities
	Notes	Total						
Cash and money at call	6	19,661	-	-	19,661	-	-	-
Placements with banks and other financial institutions	7	42,766	-	-	42,766	-	-	-
Derivative financial instruments	8(a)	1,227	1,227	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9	1,088,192	-	1,088,192	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Other assets	14	17,949	-	-	17,949	-	-	-
FINANCIAL ASSETS		1,170,288	1,227	1,088,192	80,376	-	493	-
Certificates of Indebtedness	20	156,926	-	-	-	-	-	156,926
Government-issued currency notes and coins in circulation	20	6,842	-	-	-	-	-	6,842
Balance of the banking system	21	2,035	-	-	-	-	-	2,035
Derivative financial instruments	8(a)	572	572	-	-	-	-	-
Trading liabilities	22	2,096	2,096	-	-	-	-	-
Placements by banks and other financial institutions	23	7,572	-	-	-	-	-	7,572
Placements by other HKSAR government funds	24	324,530	-	-	-	-	-	324,530
Placements by Hong Kong statutory bodies		26	-	-	-	-	-	26
Exchange Fund Bills and Notes issued	25	129,139	-	129,139	-	-	-	-
Other liabilities	28	38,947	-	-	-	-	-	38,947
FINANCIAL LIABILITIES		668,685	2,668	129,139	-	-	-	536,878

Exchange Fund - Notes on the Accounts (cont.)

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

Fund – 2005								
			Financial assets and liabilities designated					
	Notes	Total	Trading financial instruments	at fair value through profit or loss	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	15,887	–	–	15,887	–	–	–
Placements with banks and other financial institutions	7	73,120	–	–	73,120	–	–	–
Derivative financial instruments	8(a)	1,865	1,865	–	–	–	–	–
Financial assets designated at fair value through profit or loss	9	953,145	–	953,145	–	–	–	–
Available-for-sale securities	10	493	–	–	–	–	493	–
Other assets	14	16,149	–	–	16,149	–	–	–
FINANCIAL ASSETS		1,060,659	1,865	953,145	105,156	–	493	–
Certificates of indebtedness	20	148,406	–	–	–	–	–	148,406
Government-issued currency notes and coins in circulation	20	6,671	–	–	–	–	–	6,671
Balance of the banking system	21	1,561	–	–	–	–	–	1,561
Derivative financial instruments	8(a)	525	525	–	–	–	–	–
Trading liabilities	22	7,412	7,412	–	–	–	–	–
Placements by banks and other financial institutions	23	25,712	–	–	–	–	–	25,712
Placements by other HKSAR government funds	24	297,086	–	–	–	–	–	297,086
Exchange Fund Bills and Notes issued	25	118,134	–	118,134	–	–	–	–
Other liabilities	28	18,146	–	–	–	–	–	18,146
FINANCIAL LIABILITIES		623,653	7,937	118,134	–	–	–	497,582

Exchange Fund - Notes on the Accounts (cont.)

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

6 CASH AND MONEY AT CALL

	Group		Fund	
	2006	2005	2006	2005
At amortised cost				
Balance with central banks	691	619	691	619
Balance with banks	19,035	15,318	18,970	15,268
TOTAL	19,726	15,937	19,661	15,887

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2006	2005 (restated)	2006	2005
At amortised cost				
Placements in respect of reverse repurchase agreements				
– with central banks	1,988	200	1,988	200
– with banks and other financial institutions	4,518	5,488	4,518	5,488
Other placements with banks	38,164	69,979	36,260	67,432
TOTAL	44,670	75,667	42,766	73,120

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.

The Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies for the Fund. The principal derivative financial instruments used are interest rate and currency swap contracts, forward foreign exchange 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 Fund's overall market risk exposure. The credit risk arising from these transactions is marked against the Fund's overall credit exposure to individual counterparties. The risk management approaches of the Fund are outlined in note 36.

Exchange Fund - Notes on the Accounts (cont.)

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

(a) Fair values of derivative financial instruments

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

	Group				Fund			
	2006		2005 (restated)		2006		2005	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	389	56	454	110	344	8	421	32
Currency derivatives								
Forward foreign exchange contracts	880	557	1,441	411	880	535	1,441	410
Others								
Stock index futures contracts	2	29	3	82	2	29	3	82
Bond futures contracts	1	-	-	1	1	-	-	1
	1,272	642	1,898	604	1,227	572	1,865	525
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	218	93	55	264	-	-	-	-
Currency derivatives								
Currency swap contracts	-	-	-	1	-	-	-	-
	218	93	55	265	-	-	-	-
TOTAL	1,490	735	1,953	869	1,227	572	1,865	525

The fair value hedges consist of interest rate swap contracts and cross currency 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.

Exchange Fund - Notes on the Accounts (cont.)

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

(b) Notional amounts of derivative financial instruments

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

	Group									
	Notional amounts with remaining life of									
	2006					2005				
	Total	<3 months	3-12 months	1-5 years	>5 years	Total	<3 months	3-12 months	1-5 years	>5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	57,153	16,118	19,369	16,814	4,852	47,908	9,040	22,903	11,965	4,000
Currency derivatives										
Forward foreign exchange contracts	179,967	174,970	4,997	-	-	170,673	170,614	59	-	-
Others										
Stock index futures contracts	13,502	13,502	-	-	-	12,736	12,736	-	-	-
Bond futures contracts	2,065	2,065	-	-	-	915	915	-	-	-
	252,687	206,655	24,366	16,814	4,852	232,232	193,305	22,962	11,965	4,000
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	25,199	3,793	4,099	14,932	2,375	21,601	1,900	8,423	6,843	4,435
Currency derivatives										
Currency swap contracts	425	-	-	425	-	83	-	83	-	-
	25,624	3,793	4,099	15,357	2,375	21,684	1,900	8,506	6,843	4,435
TOTAL	278,311	210,448	28,465	32,171	7,227	253,916	195,205	31,468	18,808	8,435

Exchange Fund - Notes on the Accounts (cont.)

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

	Fund									
	Notional amounts with remaining life of									
	2006					2005				
	Total	<3 months	3-12 months	1-5 years	>5 years	Total	<3 months	3-12 months	1-5 years	>5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	7,400	500	1,500	2,400	3,000	7,900	-	500	3,400	4,000
Currency derivatives										
Forward foreign exchange contracts	164,157	164,143	14	-	-	170,615	170,614	1	-	-
Others										
Stock index futures contracts	13,502	13,502	-	-	-	12,736	12,736	-	-	-
Bond futures contracts	2,065	2,065	-	-	-	915	915	-	-	-
TOTAL	187,124	180,210	1,514	2,400	3,000	192,166	184,265	501	3,400	4,000

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

At fair value	Group and Fund	
	2006	2005 (restated)
Debt securities		
Treasury bills and commercial paper		
Listed outside Hong Kong	289	1,637
Unlisted	140,000	170,896
Certificates of deposit		
Unlisted	20,050	21,908
Other debt securities		
Listed		
In Hong Kong	182	187
Outside Hong Kong	292,732	284,243
Unlisted	375,107	262,172
Total debt securities	828,360	741,043
Equity securities		
Listed		
In Hong Kong	122,445	87,872
Outside Hong Kong	137,387	124,230
Total equity securities	259,832	212,102
TOTAL	1,088,192	953,145

Exchange Fund - Notes on the Accounts (cont.)

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

10 AVAILABLE-FOR-SALE SECURITIES

	Group		Fund	
	2006	2005	2006	2005
Debt securities, at fair value				
Listed				
In Hong Kong	163	16	–	–
Outside Hong Kong	283	–	–	–
Unlisted	3,626	1,563	–	–
	4,072	1,579	–	–
Equity securities				
Listed in Hong Kong, at fair value	542	411	–	–
Unlisted, at cost	493	493	493	493
TOTAL	5,107	2,483	493	493

The Group's investment in unlisted equity securities at 31 December 2006 represents a holding of 4,285 shares (2005: 4,285 shares) in the Bank for International Settlements (also see note 34(a)) with a nominal value of 5,000 Special Drawing Rights each. These shares are 25% paid. As these shares are not freely transferable, no estimate of their fair values is made.

11 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2006	2005 (restated)	2006	2005
At amortised cost				
Debt securities				
Listed				
In Hong Kong	586	593	–	–
Outside Hong Kong	1,012	998	–	–
Unlisted	3,155	2,994	–	–
TOTAL	4,753	4,585	–	–

Exchange Fund - Notes on the Accounts (cont.)

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

12 LOAN PORTFOLIO

	Group		Fund	
	2006	2005 (restated)	2006	2005
Outstanding principal balance of mortgage loans, at amortised cost	31,133	33,605	–	–
Outstanding principal balance of non-mortgage loans, at amortised cost	1,291	–	–	–
Allowance for loan impairment	(30)	(56)	–	–
TOTAL	32,394	33,549	–	–

13 GOLD

	Group and Fund	
	2006	2005
Gold, at market value		
66,798 ounces (2005: 66,798 ounces)	330	266

14 OTHER ASSETS

	Group		Fund	
	2006	2005 (restated)	2006	2005
Interest and dividends receivable	10,553	8,812	9,977	8,475
Prepayments, receivables and other assets	4,673	4,717	4,272	4,186
Unsettled sales and redemption of securities	3,427	3,225	3,427	3,225
Staff housing loans	273	263	273	263
Tax recoverable	–	6	–	–
TOTAL	18,926	17,023	17,949	16,149

Exchange Fund - Notes on the Accounts (cont.)

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

15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2006	2005
Unlisted shares, at cost	2,145	2,145

The following is a list of the principal subsidiaries as at 31 December 2006 and 2005:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund'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%

The above subsidiaries are held directly by the Fund.

The HKMC has unissued authorised share capital of HK\$1 billion (2005: HK\$1 billion), which is callable from the Fund.

16 INTEREST IN ASSOCIATE

	Group		Fund	
	2006	2005	2006	2005
Unlisted shares, at cost	–	–	–	–
Share of net assets	35	26	–	–
TOTAL	35	26	–	–

Investment in associate comprises unlisted shares of Hong Kong Interbank Clearing Limited directly held by the Fund at a cost of HK\$5,000 (2005: HK\$5,000). Details of the associate are as follows:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Interbank Clearing Limited	Hong Kong	Interbank clearing	HK\$10,000	50%

Exchange Fund - Notes on the Accounts (cont.)

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

17 PROPERTY, PLANT AND EQUIPMENT

(a)

	Group		
	Premises	Plant and equipment	Total
Cost			
At 1 January 2005	623	553	1,176
Additions	–	65	65
Disposals	(2)	(6)	(8)
At 31 December 2005	621	612	1,233
At 1 January 2006	621	612	1,233
Additions	1	26	27
Disposals	–	(3)	(3)
At 31 December 2006	622	635	1,257
Accumulated depreciation			
At 1 January 2005	19	272	291
Charge for the year	13	47	60
Written back on disposal	–	(6)	(6)
At 31 December 2005	32	313	345
At 1 January 2006	32	313	345
Charge for the year	14	48	62
Written back on disposal	–	(3)	(3)
At 31 December 2006	46	358	404
Net book value			
At 31 December 2006	576	277	853
At 31 December 2005	589	299	888

Exchange Fund - Notes on the Accounts (cont.)

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

	Fund		
	Premises	Plant and equipment	Total
Cost			
At 1 January 2005	614	181	795
Additions	–	21	21
Disposals	(2)	(5)	(7)
At 31 December 2005	612	197	809
At 1 January 2006	612	197	809
Additions	–	16	16
Disposals	–	(2)	(2)
At 31 December 2006	612	211	823
Accumulated depreciation			
At 1 January 2005	18	142	160
Charge for the year	13	16	29
Written back on disposal	–	(5)	(5)
At 31 December 2005	31	153	184
At 1 January 2006	31	153	184
Charge for the year	13	17	30
Written back on disposal	–	(2)	(2)
At 31 December 2006	44	168	212
Net book value			
At 31 December 2006	568	43	611
At 31 December 2005	581	44	625

(b) The net book value of premises comprises:

	Group		Fund	
	2006	2005	2006	2005
In Hong Kong				
Buildings situated on land held on medium-term leases (between 10 and 50 years)	552	565	544	557
Outside Hong Kong				
Freehold land and the building situated thereon	24	24	24	24
TOTAL	576	589	568	581

Exchange Fund - Notes on the Accounts (cont.)

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

18 OPERATING LAND LEASE PREPAYMENT

	Group and Fund	
	2006	2005
Cost		
At 1 January and 31 December	3,231	3,231
Accumulated amortisation		
At 1 January	160	86
Charge for the year	74	74
At 31 December	234	160
Net book value		
At 31 December	2,997	3,071

19 INTANGIBLE ASSETS

	Group and Fund	
	Computer software licences and system development costs	
	2006	2005
Cost		
At 1 January	232	228
Additions	2	4
At 31 December	234	232
Accumulated amortisation		
At 1 January	199	186
Charge for the year	13	13
At 31 December	212	199
Net book value		
At 31 December	22	33

Exchange Fund - Notes on the Accounts (cont.)

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

20 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	
	2006	2005	2006	2005
Carrying amount	156,926	148,406	6,842	6,671
Reconciliation with face value:				
Hong Kong dollar face value	HK\$157,385	HK\$149,295	HK\$6,862	HK\$6,711
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\$20,178	US\$19,140	US\$880	US\$860
Market exchange rate for translation into Hong Kong dollars	US\$1=HK\$7.77725	US\$1=HK\$7.7536	US\$1=HK\$7.77725	US\$1=HK\$7.7536
Carrying amount	HK\$156,926	HK\$148,406	HK\$6,842	HK\$6,671

21 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 HKMA for the account of the Fund. The aggregate amounts 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 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 on the Accounts (cont.)

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

22 TRADING LIABILITIES

	Group and Fund	
	2006	2005
At fair value		
Short positions in Exchange Fund Bills and Notes (note 25)	2,096	7,412

23 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2006	2005
At amortised cost		
Placements by banks and other financial institutions in respect of securities lending (note 32)	–	1,001
Other placements by banks	7,572	24,711
TOTAL	7,572	25,712

Exchange Fund - Notes on the Accounts (cont.)

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

24 PLACEMENTS BY OTHER HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT FUNDS

	Group and Fund	
	2006	2005
Placements with interest payable at rates determined by reference to the investment income of the Fund		
General Revenue Account	114,840	101,006
Land Fund	128,560	124,334
Capital Works Reserve Fund	51,811	44,273
Civil Service Pension Reserve Fund	15,814	15,294
Disaster Relief Fund	28	32
Innovation and Technology Fund	4,081	4,332
Lotteries Fund	4,870	4,569
	320,004	293,840
Placements with interest payable at market-based rates		
General Revenue Account	264	288
Capital Investment Fund	765	852
Loan Fund	2,909	1,295
Capital Works Reserve Fund	356	488
Innovation and Technology Fund	80	92
Lotteries Fund	152	231
	4,526	3,246
TOTAL	324,530	297,086

Placements by other HKSAR government funds are not permanently appropriated for the use of the Fund, and the majority are repayable on demand. As at 31 December 2006, the interest payable on these placements amounted to HK\$28,949 million (2005: HK\$10,068 million) and is included in "other liabilities" (note 28).

Exchange Fund - Notes on the Accounts (cont.)

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

25 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group and Fund	
	2006	2005
At fair value		
Exchange Fund Bills and Notes issued		
Exchange Fund Bills	69,526	69,384
Exchange Fund Notes	62,587	57,019
	132,113	126,403
Exchange Fund Bills and Notes held		
Exchange Fund Bills	(2,066)	(7,333)
Exchange Fund Notes	(908)	(936)
	(2,974)	(8,269)
TOTAL	129,139	118,134

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 and 10-year maturities. EFBN issued are valued at offer prices derived from Reuters fixings 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.

Short positions in EFBN resulting from market making activities are categorised as "trading liabilities" in accordance with HKAS 39. As at 31 December 2006, short positions in EFBN amounted to HK\$2,096 million (2005: HK\$7,412 million) (note 22).

Exchange Fund - Notes on the Accounts (cont.)

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

The reconciliation of the redemption amount of EFBN issued at the beginning and the end of year is set out below:

	Group and Fund			
	2006		2005	
	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Redemption amount				
Exchange Fund Bills and Notes issued by Currency Board Operations segment				
At 1 January	70,009	56,700	68,579	54,000
Issuance	201,015	17,600	197,261	16,500
Redemption	(200,936)	(12,600)	(195,831)	(13,800)
At 31 December	70,088	61,700	70,009	56,700
Long position in Exchange Fund Bills and Notes held by Financial Stability and Other Activities segment at 31 December	(2,069)	(877)	(7,359)	(877)
Total redemption amount	68,019	60,823	62,650	55,823
Carrying amount, at fair value	67,460	61,679	62,051	56,083
Difference	559	(856)	599	(260)

The fair value changes of EFBN issued are attributable to changes in benchmark interest rates.

26 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2006	2005	2006	2005
Debt securities issued, carried at amortised cost				
Notes	3,849	3,900	–	–
Debt securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk				
Notes	22,080	21,491	–	–
	25,929	25,391	–	–
Debt securities issued, designated at fair value through profit or loss				
Notes	2,981	2,600	–	–
TOTAL	28,910	27,991	–	–

Exchange Fund - Notes on the Accounts (cont.)

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

The reconciliation of the redemption amount of other debt securities issued at the beginning and the end of year is set out below:

	Group		Fund	
	2006	2005	2006	2005
Total debt securities issued				
Redemption amount at 1 January	28,243	35,495	–	–
Issuance	13,323	5,096	–	–
Redemption	(12,699)	(12,348)	–	–
Redemption amount at 31 December	28,867	28,243	–	–
Carrying amount	28,910	27,991	–	–
Difference	(43)	252	–	–
Debt securities issued, designated at fair value through profit or loss:				
Redemption amount	3,069	2,664	–	–
Carrying amount, at fair value	2,981	2,600	–	–
Difference	88	64	–	–

The fair value changes of debt securities issued designated at fair value through profit or loss are attributable to changes in benchmark interest rates.

27 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2006	2005 (restated)	2006	2005
Mortgage-backed securities issued, carried at amortised cost	2,127	3,698	–	–
Mortgage-backed securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk	3,214	1,447	–	–
TOTAL	5,341	5,145	–	–

Exchange Fund - Notes on the Accounts (cont.)

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

The reconciliation of the redemption amount of mortgage-backed securities issued at the beginning and the end of year is set out below:

	Group		Fund	
	2006	2005 (restated)	2006	2005
Total mortgage-backed securities issued				
Redemption amount at 1 January	5,177	5,869	–	–
Issuance	2,000	980	–	–
Redemption	(1,830)	(1,671)	–	–
Redemption amount at 31 December	5,347	5,178	–	–
Carrying amount	5,341	5,145	–	–
Difference	6	33	–	–

28 OTHER LIABILITIES

	Group		Fund	
	2006	2005 (restated)	2006	2005
Interest payable on placements by other HKSAR government funds – at rates determined by reference to the investment income of the Fund – at market-based rates	28,936 13	10,060 8	28,936 13	10,060 8
Other interest payable	871	849	521	591
Unsettled purchases of securities	9,149	7,183	9,149	7,183
Accrued charges and other liabilities	5,177	5,379	328	304
Tax payable	20	–	–	–
Deferred tax liabilities	65	62	–	–
TOTAL	44,231	23,541	38,947	18,146

Exchange Fund - Notes on the Accounts (cont.)

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

29 EQUITY

	Group		Fund	
	2006	2005 (restated)	2006	2005
Accumulated surplus				
At 1 January, as previously reported	445,828	425,139	443,146	422,821
Prior year adjustment (note 3.1.2)	(2)	(3)	–	–
At 1 January, as restated	445,826	425,136	443,146	422,821
Surplus for the year	64,987	20,690	64,562	20,325
At 31 December	510,813	445,826	507,708	443,146
Available-for-sale securities revaluation reserve				
At 1 January	94	–	–	–
Net fair value gains, net of tax	31	87	–	–
Net losses transferred to income and expenditure account on disposal	–	7	–	–
At 31 December	125	94	–	–
Minority interests				
At 1 January	178	167	–	–
Surplus for the year	14	23	–	–
Dividends paid to minority interests	(18)	(12)	–	–
At 31 December	174	178	–	–
TOTAL	511,112	446,098	507,708	443,146

30 NOTES TO THE CASH FLOW STATEMENT

Analysis of cash and cash equivalents in the cash flow statement

	Group		Fund	
	2006	2005 (restated)	2006	2005
Cash and money at call	19,726	15,937	19,661	15,887
Placements with banks and other financial institutions	42,938	75,658	41,231	73,120
Treasury bills and commercial paper	34,943	112,776	34,943	112,776
Certificates of deposit	1,830	14,170	1,830	14,170
TOTAL	99,437	218,541	97,665	215,953

Exchange Fund - Notes on the Accounts (cont.)

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

Reconciliation with the balance sheet

	Note	Group		Fund	
		2006	2005 (restated)	2006	2005
Amounts shown in the balance sheet					
Cash and money at call	6	19,726	15,937	19,661	15,887
Placements with banks and other financial institutions	7	44,670	75,667	42,766	73,120
Financial assets designated at fair value through profit or loss					
– Treasury bills and commercial paper	9	140,289	172,533	140,289	172,533
– Certificates of deposit	9	20,050	21,908	20,050	21,908
		224,735	286,045	222,766	283,448
Less: Amounts with original maturity beyond 3 months		(125,298)	(67,504)	(125,101)	(67,495)
Cash and cash equivalents in the cash flow statement		99,437	218,541	97,665	215,953

31 SEGMENT REPORTING

The activities of the Group comprise the following business segments:

- Management of funds under the Currency Board Operations;
- Management of funds representing the general reserve assets of the Fund; and
- Maintaining the stability and integrity of monetary and financial systems of Hong Kong, including banking supervision, monetary management and the activities of the subsidiaries.

Exchange Fund - Notes on the Accounts (cont.)

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

	Currency Board Operations		Reserves Management		Group Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Total	
	2006	2005	2006	2005	2006	2005	2006	2005 (restated)	2006	2005 (restated)
Income	13,462	10,842	89,643	26,341	103,105	37,183	3,108	2,581	106,213	39,764
Expenditure										
Interest expense	4,936	3,062	32,385	12,843	37,321	15,905	1,675	1,232	38,996	17,137
Other expenses (note 31(b))	-	-	-	-	1,118	818	1,020	999	2,138	1,817
	4,936	3,062	32,385	12,843	38,439	16,723	2,695	2,231	41,134	18,954
Surplus before share of profit of associate	8,526	7,780	57,258	13,498	64,666	20,460	413	350	65,079	20,810
Share of profit of associate	-	-	-	-	-	-	8	3	8	3
Surplus before taxation	8,526	7,780	57,258	13,498	64,666	20,460	421	353	65,087	20,813
Income tax	-	-	-	-	-	-	(86)	(100)	(86)	(100)
Surplus for the year	8,526	7,780	57,258	13,498	64,666	20,460	335	253	65,001	20,713
Attributable to:										
Owner of the Fund	8,526	7,780	57,258	13,498	64,666	20,460	321	230	64,987	20,690
Minority interests	-	-	-	-	-	-	14	23	14	23
	8,526	7,780	57,258	13,498	64,666	20,460	335	253	65,001	20,713

Exchange Fund

Exchange Fund - Notes on the Accounts (cont.)

(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 31(c) & (d))		Total	
	2006	2005	2006	2005	2006	2005	2006	2005 (restated)	2006	2005	2006	2005 (restated)
Assets												
Backing Assets												
Investment in designated												
US dollar assets	328,567	314,228	-	-	328,567	314,228	-	-	-	-	328,567	314,228
Interest receivable on												
designated US dollar assets	1,963	1,408	-	-	1,963	1,408	-	-	-	-	1,963	1,408
Net accounts receivable	2,143	1,221	-	-	2,143	1,221	-	-	1	52	2,144	1,273
Other investments	-	-	821,411	727,638	821,411	727,638	47,473	51,751	(2,244)	(7,959)	866,640	771,430
Other assets	-	-	14,422	14,617	14,422	14,617	5,570	5,521	189	149	20,181	20,287
TOTAL ASSETS	332,673	316,857	835,833	742,255	1,168,506	1,059,112	53,043	57,272	(2,054)	(7,758)	1,219,495	1,108,626
Liabilities												
Monetary Base												
Certificates of Indebtedness	156,926	148,406	-	-	156,926	148,406	-	-	-	-	156,926	148,406
Government-issued currency notes and coins												
in circulation	6,842	6,671	-	-	6,842	6,671	-	-	-	-	6,842	6,671
Balance of the banking system	2,035	1,561	-	-	2,035	1,561	-	-	-	-	2,035	1,561
Exchange Fund Bills and Notes issued	132,113	126,403	-	-	132,113	126,403	-	-	(2,974)	(8,269)	129,139	118,134
Interest payable on Exchange Fund Notes	467	431	-	-	467	431	-	-	-	-	467	431
Net accounts (receivable)/payable	(911)	(426)	-	-	(911)	(426)	-	-	919	459	8	33
Other debt securities issued	-	-	-	-	-	-	28,910	27,991	-	-	28,910	27,991
Mortgage-backed securities issued	-	-	-	-	-	-	5,341	5,145	-	-	5,341	5,145
Placements by banks and other financial institutions	-	-	7,572	25,712	7,572	25,712	-	-	-	-	7,572	25,712
Placements by other HKSAR government funds	-	-	324,530	297,086	324,530	297,086	-	-	-	-	324,530	297,086
Placements by Hong Kong statutory bodies	-	-	-	-	-	-	26	-	-	-	26	-
Other liabilities	-	-	38,979	18,085	38,979	18,085	7,607	13,221	1	52	46,587	31,358
Total liabilities	297,472	283,046	371,081	340,883	668,553	623,929	41,884	46,357	(2,054)	(7,758)	708,383	662,528
Accumulated surplus												
At 1 January	33,811	32,361	401,372	381,153	435,183	413,514	10,643	11,622	-	-	445,826	425,136
Surplus for the year attributable to owner of the Fund	8,526	7,780	57,258	13,498	64,666	20,460	321	230	-	-	64,987	20,690
Transfer between Currency Board Operations and general reserves (note 31(e))	(7,136)	(6,330)	6,122	6,721	104	1,209	(104)	(1,209)	-	-	-	-
At 31 December	35,201	33,811	464,752	401,372	499,953	435,183	10,860	10,643	-	-	511,813	445,826
Revaluation reserve	-	-	-	-	-	-	125	94	-	-	125	94
Minority interests	-	-	-	-	-	-	174	178	-	-	174	178
Total equity	35,201	33,811	464,752	401,372	499,953	435,183	11,159	10,915	-	-	511,112	446,098
TOTAL LIABILITIES AND EQUITY	332,673	316,857	835,833	742,255	1,168,506	1,059,112	53,043	57,272	(2,054)	(7,758)	1,219,495	1,108,626

Exchange Fund - Notes on the Accounts (cont.)

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

(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. 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 Currency Board Operations segment and Reserves Management segment are aggregated as there is no meaningful basis to allocate between these two segments.

(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 2006, deduction from the Backing Assets comprises:

- "other liabilities" of HK\$1 million (2005: HK\$52 million) - Accounts payable for unsettled transactions of redemption of Certificates of Indebtedness are included in "net accounts receivable" in arriving at the Backing Assets.

As at 31 December 2006, deductions from the Monetary Base comprise:

- "other assets" of HK\$189 million (2005: HK\$149 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\$3 million (2005: HK\$2 million) and revaluation gains of HK\$186 million (2005: HK\$147 million) on these interest rate swaps are included in "net accounts payable" to reduce the Monetary Base; and
- "other investments" of HK\$730 million (2005: HK\$310 million) - When Hong Kong dollar overnight advances secured on EFBN have been made to banks under the Discount Window Operations, the advances are included in "net accounts receivable" to reduce the amount of the balance of the banking system in arriving at 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 on the Accounts (cont.)

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

32 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.

	Group		Fund	
	2006	2005	2006	2005
Secured liabilities				
Placements by banks and other financial institutions in respect of securities lending (note 23)	–	1,001	–	1,001
Stock index futures contracts - notional amount (note 8(b))	13,502	12,736	13,502	12,736
Bond futures contracts - notional amount (note 8(b))	2,065	915	2,065	915
Mortgage-backed securities issued (note 27)	5,341	5,145	–	–
Assets pledged				
Financial assets designated at fair value through profit or loss, carried at fair value	905	1,978	905	1,978
Placements with banks	384	19	–	–
Mortgage loans	4,878	5,052	–	–

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.

33 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	
	2006	2005	2006	2005
Authorised but not contracted for	39	62	27	50

Exchange Fund - Notes on the Accounts (cont.)

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

(b) Credit facility to the International Monetary Fund

On 27 January 1997, the HKMA 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. At 31 December 2006, the HKMA had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$3,978 million equivalent (2005: HK\$3,768 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2006, there was no outstanding balance due from the IMF under this NAB facility (2005: Nil).

(c) Repurchase agreements with other central banks

The HKMA has entered into bilateral repurchase agreements with various central banks in Asia and Australasia. The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. No transactions took place under this arrangement with any central bank during the years ended 31 December 2005 and 2006.

(d) Lease commitments

At 31 December 2006, the total future minimum lease payments under non-cancellable operating leases of premises were payable as follows:

	Group		Fund	
	2006	2005	2006	2005
Not later than one year	3	3	3	3
Later than one year and not later than five years	4	6	4	6
Later than five years	3	3	3	3
TOTAL	10	12	10	12

34 CONTINGENT LIABILITIES

- (a) At 31 December 2006, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$188 million equivalent (2005: 16.1 million Special Drawing Rights or HK\$178 million equivalent), in respect of the uncalled portion of its 4,285 shares (2005: 4,285 shares) in the Bank for International Settlements (note 10).
- (b) Under the Mortgage Insurance Programme, the HKMC offers mortgage insurance that covers approved sellers for credit losses of up to 25% of the value of properties financed under mortgage loans where the loan amount exceeds 70% of the property value at origination. The HKMC reinsures the exposure with approved reinsurers. At 31 December 2006, the total risk-in-force assumed by the HKMC was HK\$2.92 billion (2005: HK\$2.64 billion).

Exchange Fund - Notes on the Accounts (cont.)

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

35 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, the Group entered into the following material related party transactions.

During the year, the HKMC purchased HK\$107 million (2005: HK\$174 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 Exchange Fund. Members of 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 Fund and on terms consistent with its ongoing operations.

36 RISK MANAGEMENT

36.1 Governance

The Financial Secretary is advised by EFAC in his control of the Exchange Fund. 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. Members of 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 includes knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

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.

Among these Sub-Committees, the Investment Sub-Committee monitors the HKMA's investment management activities and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. Operating within the policies and guidelines endorsed by EFAC, the Reserves Management Department conducts the day-to-day investment management and risk management of the Fund.

36.2 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 long-term 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 EFAC.

Exchange Fund - Notes on the Accounts (cont.)

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

The Fund's asset allocation and currency mix set out in the existing investment benchmark are as follows:

	2006 and 2005
Asset type	
Bonds	77%
Equities and related investments	23%
	100%
Currency	
US\$ bloc ¹	88%
Other currencies	12%
	100%

¹ HK dollar, US dollar and other foreign currencies including Australian dollar, Canadian dollar and New Zealand dollar.

In addition to the investment benchmark, EFAC determines the tactical deviation limits governing the extent to which the Fund's asset and currency allocations 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 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.

36.3 Risks faced by the Fund

36.3.1 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.

(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.

Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates. The Fund 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 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.

Exchange Fund - Notes on the Accounts (cont.)

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

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 Fund has no significant floating rate investments and liabilities, the Fund's future cash flows are not materially affected by potential changes in market interest rates.

As explained in note 24, a significant portion of the Fund's liabilities represents funds placed by other HKSAR government funds that bear interest at rates determined by reference to returns generated on the Fund's assets. As a result, no significant interest rate risk arises in respect of these liabilities, which amounted to HK\$320,004 million (2005: HK\$293,840 million) at 31 December 2006.

The tables below set out the Group's and Fund's exposure to interest rate risk, based on the major interest bearing assets and liabilities stated at carrying amounts and categorised by the earlier of contractual re-pricing dates or maturity dates and stating the weighted average effective interest rate for each group of assets and liabilities.

	Group - 2006 Repricing period								Non-interest bearing
	Weighted average effective interest rate	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	Interest bearing total	
Assets									
Cash and money at call	5.09%	19,559	-	-	-	-	-	19,559	167
Placements with banks and other financial institutions	4.93%	43,560	895	197	-	-	-	44,652	18
Financial assets designated at fair value through profit or loss	4.78%	65,080	64,679	141,555	288,600	206,551	42,336	808,801	279,391
Available-for-sale securities	5.46%	2,476	456	140	763	237	-	4,072	1,035
Held-to-maturity securities	4.46%	250	391	652	2,297	1,163	-	4,753	-
Loan portfolio	5.20%	28,237	4,050	69	36	2	-	32,394	-
Interest-bearing assets		159,162	70,471	142,613	291,696	207,953	42,336	914,231	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(35,192)	(18,197)	(39,352)	(80,230)	(57,420)	(11,769)	(242,160)	(77,844)
Net interest-bearing assets supporting liabilities bearing interest at market-based rates		123,970	52,274	103,261	211,466	150,533	30,567	672,071	
Liabilities									
Trading liabilities	2.40%	1,724	372	-	-	-	-	2,096	-
Placements by banks and other financial institutions	4.25%	7,572	-	-	-	-	-	7,572	-
Placements by other HKSAR government funds with interest payable at market-based rates	3.49%	2,408	2,118	-	-	-	-	4,526	-
Placements by Hong Kong statutory bodies	3.48%	26	-	-	-	-	-	26	-
Exchange Fund Bills and Notes issued	3.30%	14,855	35,568	30,941	36,731	11,044	-	129,139	-
Other debt securities issued	4.20%	2,799	5,789	4,938	13,025	1,344	1,015	28,910	-
Mortgage-backed securities issued	4.11%	2,127	-	676	2,538	-	-	5,341	-
Interest-bearing liabilities		31,511	43,847	36,555	52,294	12,388	1,015	177,610	
Interest rate sensitivity gap		92,459	8,427	66,706	159,172	138,145	29,552	494,461	

Exchange Fund - Notes on the Accounts (cont.)

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

- ¹ Placements by other HKSAR government funds at rates determined by reference to the investment income of the Fund have the same interest rate risk profile as the Fund. Amounts placed by such funds have therefore been allocated across the repricing periods in the same proportion as the total assets of the Fund.

	Weighted average effective interest rate	Group - 2005 (restated) Repricing period						Interest bearing total	Non- interest bearing
		Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets									
Cash and money at call	4.10%	15,416	-	-	-	-	-	15,416	521
Placements with banks and other financial institutions	4.08%	74,471	1,186	10	-	-	-	75,667	-
Financial assets designated at fair value through profit or loss	4.09%	132,616	78,134	54,389	280,760	151,737	37,666	735,302	217,843
Available-for-sale securities	4.35%	851	728	-	-	-	-	1,579	904
Held-to-maturity securities	4.47%	-	685	516	2,222	1,162	-	4,585	-
Loan portfolio	5.48%	33,166	230	81	72	-	-	33,549	-
Interest-bearing assets		256,520	80,963	54,996	283,054	152,899	37,666	866,098	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(61,985)	(22,348)	(15,328)	(79,124)	(42,763)	(10,615)	(232,163)	(61,677)
Net interest-bearing assets									
supporting liabilities bearing interest at market-based rates		194,535	58,615	39,668	203,930	110,136	27,051	633,935	
Liabilities									
Trading liabilities	3.50%	1,416	5,966	30	-	-	-	7,412	-
Placements by banks and other financial institutions	3.89%	19,712	6,000	-	-	-	-	25,712	-
Placements by other HKSAR government funds with interest payable at market-based rates	3.55%	2,786	460	-	-	-	-	3,246	-
Exchange Fund Bills and Notes issued	3.77%	12,651	32,004	30,022	33,279	10,178	-	118,134	-
Other debt securities issued	4.22%	2,780	3,806	9,297	7,747	3,446	915	27,991	-
Mortgage-backed securities issued	4.12%	3,698	-	-	1,447	-	-	5,145	-
Interest-bearing liabilities		43,043	48,236	39,349	42,473	13,624	915	187,640	
Interest rate sensitivity gap		151,492	10,379	319	161,457	96,512	26,136	446,295	

Exchange Fund - Notes on the Accounts (cont.)

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

Fund - 2006 Repricing period									
	Weighted average effective interest rate	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	Interest bearing total	Non- interest bearing
Assets									
Cash and money at call	5.09%	19,525	-	-	-	-	-	19,525	136
Placements with banks and other financial institutions	4.94%	41,988	778	-	-	-	-	42,766	-
Financial assets designated at fair value through profit or loss	4.78%	65,080	64,679	141,555	288,600	206,551	42,336	808,801	279,391
Available-for-sale securities	-	-	-	-	-	-	-	-	493
Interest-bearing assets		126,593	65,457	141,555	288,600	206,551	42,336	871,092	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(35,192)	(18,197)	(39,352)	(80,230)	(57,420)	(11,769)	(242,160)	(77,844)
Net interest-bearing assets supporting liabilities bearing interest at market-based rates		91,401	47,260	102,203	208,370	149,131	30,567	628,932	
Liabilities									
Trading liabilities	2.40%	1,724	372	-	-	-	-	2,096	-
Placements by banks and other financial institutions	4.25%	7,572	-	-	-	-	-	7,572	-
Placements by other HKSAR government funds with interest payable at market-based rates	3.49%	2,408	2,118	-	-	-	-	4,526	-
Placements by Hong Kong statutory bodies	3.48%	26	-	-	-	-	-	26	-
Exchange Fund Bills and Notes issued	3.30%	14,855	35,568	30,941	36,731	11,044	-	129,139	-
Interest-bearing liabilities		26,585	38,058	30,941	36,731	11,044	-	143,359	
Interest rate sensitivity gap		64,816	9,202	71,262	171,639	138,087	30,567	485,573	

Exchange Fund - Notes on the Accounts (cont.)

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

	Weighted average effective interest rate	Fund - 2005 Repricing period						Interest bearing total	Non- interest bearing
		Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets									
Cash and money at call	4.10%	15,371	-	-	-	-	-	15,371	516
Placements with banks and other financial institutions	4.08%	71,957	1,163	-	-	-	-	73,120	-
Financial assets designated at fair value through profit or loss	4.09%	132,616	78,134	54,389	280,760	151,737	37,666	735,302	217,843
Available-for-sale securities	-	-	-	-	-	-	-	-	493
Interest-bearing assets		219,944	79,297	54,389	280,760	151,737	37,666	823,793	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(61,985)	(22,348)	(15,328)	(79,124)	(42,763)	(10,615)	(232,163)	(61,677)
Net interest-bearing assets supporting liabilities bearing interest at market-based rates		157,959	56,949	39,061	201,636	108,974	27,051	591,630	
Liabilities									
Trading liabilities	3.50%	1,416	5,966	30	-	-	-	7,412	-
Placements by banks and other financial institutions	3.89%	19,712	6,000	-	-	-	-	25,712	-
Placements by other HKSAR government funds with interest payable at market-based rates	3.55%	2,786	460	-	-	-	-	3,246	-
Exchange Fund Bills and Notes issued	3.77%	12,651	32,004	30,022	33,279	10,178	-	118,134	-
Interest-bearing liabilities		36,565	44,430	30,052	33,279	10,178	-	154,504	
Interest rate sensitivity gap		121,394	12,519	9,009	168,357	98,796	27,051	437,126	

(b) Equity price risk

Equity price risk is the risk of loss arising from changes in equity prices. The Fund's equity investments are subject to equity price risk since the value of these investments will decline if equity prices fall. At 31 December 2005 and 2006, the majority of equity investments are reported as "financial assets designated at fair value through profit or loss" as shown in note 9.

(c) Currency risk

Currency risk is the risk of loss arising from changes in foreign exchange rates. A large portion of 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.

Exchange Fund - Notes on the Accounts (cont.)

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

Due to the linked exchange rate of the US dollar relative to the Hong Kong dollar, the Fund's currency risk principally arises from its assets and liabilities denominated in "non-US dollar bloc" currencies.

The table below represents the aggregate Hong Kong dollar equivalents of foreign currency holdings of the Fund:

	Group			
	2006		2005 (restated)	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	166.8	534.3	132.4	498.4
Other US dollar bloc currencies ¹	917.0	173.6	848.2	162.7
	1,083.8	707.9	980.6	661.1
Non-US dollar bloc	135.7	0.5	128.0	1.4
Total	1,219.5	708.4	1,108.6	662.5

	Fund			
	2006		2005	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	130.9	495.1	95.6	459.8
Other US dollar bloc currencies ¹	909.8	173.1	843.2	162.5
	1,040.7	668.2	938.8	622.3
Non-US dollar bloc	135.7	0.5	128.0	1.4
Total	1,176.4	668.7	1,066.8	623.7

¹ US dollar and other foreign currencies including Australian dollar, Canadian dollar and New Zealand dollar.

(d) Monitoring market risks

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. As explained in note 8, the Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies for the Fund. The market risk of the Fund is measured and monitored using the Value-at-Risk (VaR) methodology.

Exchange Fund - Notes on the Accounts (cont.)

(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 both dollar amounts and percentage terms, are measured and reported on a regular basis. The relative VaR of the Fund in percentage terms is also used to measure the actual tracking error of the Fund against its investment benchmark. This is regularly monitored against the tracking error limit endorsed by EFAC to ensure that the market risk exposure of the Fund is within its limits.

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. 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 EFAC on a regular basis.

36.3.2 Liquidity risk

Liquidity risk refers to the risk that the Fund may not have sufficient funds available to meet its liabilities as they fall due. In addition, the Fund may not be able to liquidate its financial assets at a price close to fair value within a short period of time.

To ensure sufficient liquidity to meet liabilities and the ability to raise funds to meet exceptional needs, the Fund invests primarily in liquid financial markets and instruments. There are also internal investment restrictions preventing undue concentrations in individual debt securities issues, debt securities issuers, and groups of debt securities issuers. There are also limitations on the maximum proportion of the Fund's assets that can be placed in fixed term deposits, and requirements regarding the Fund's ability to convert its foreign currency assets into cash. Compliance with these limits is monitored on a regular basis.

Exchange Fund - Notes on the Accounts (cont.)

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

The tables below summarise the Group's and Fund's major financial assets and financial liabilities according to maturity groupings based on the remaining period between the balance sheet date and the contractual maturity date.

	Group - 2006							Total
	Remaining maturity							
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	Undated or on demand	
Assets								
Cash and money at call	-	-	-	-	-	-	19,726	19,726
Placements with banks and other financial institutions	43,578	895	197	-	-	-	-	44,670
Financial assets designated at fair value through profit or loss	65,080	64,679	141,555	288,600	206,551	42,336	279,391	1,088,192
Available-for-sale securities	2,679	-	141	1,015	237	-	1,035	5,107
Held-to-maturity securities	250	379	652	2,309	1,163	-	-	4,753
Loan portfolio	599	389	2,620	16,890	8,066	3,743	87	32,394
	112,186	66,342	145,165	308,814	216,017	46,079	300,239	1,194,842
Liabilities								
Certificates of Indebtedness	-	-	-	-	-	-	156,926	156,926
Government-issued currency notes and coins in circulation	-	-	-	-	-	-	6,842	6,842
Balance of the banking system	-	-	-	-	-	-	2,035	2,035
Trading liabilities	1,724	372	-	-	-	-	-	2,096
Placements by banks and other financial institutions	7,572	-	-	-	-	-	-	7,572
Placements by other HKSAR government funds	1,000	2,118	-	-	-	-	321,412	324,530
Placements by Hong Kong statutory bodies	-	-	-	-	-	-	26	26
Exchange Fund Bills and Notes issued	14,855	35,568	30,941	36,731	11,044	-	-	129,139
Other debt securities issued	949	5,191	6,636	13,775	1,344	1,015	-	28,910
Mortgage-backed securities issued	40	34	749	2,853	1,347	318	-	5,341
	26,140	43,283	38,326	53,359	13,735	1,333	487,241	663,417
Liquidity gap	86,046	23,059	106,839	255,455	202,282	44,746	(187,002)	531,425

Exchange Fund - Notes on the Accounts (cont.)

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

	Group - 2005 (restated)							Total
	Remaining maturity							
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	Undated or on demand	
Assets								
Cash and money at call	-	-	-	-	-	-	15,937	15,937
Placements with banks and other financial institutions	74,471	1,186	10	-	-	-	-	75,667
Financial assets designated at fair value through profit or loss	132,616	78,134	54,389	280,760	151,737	37,666	217,843	953,145
Available-for-sale securities	851	309	-	419	-	-	904	2,483
Held-to-maturity securities	-	669	516	2,223	1,177	-	-	4,585
Loan portfolio	470	393	2,852	14,041	11,466	4,200	127	33,549
	208,408	80,691	57,767	297,443	164,380	41,866	234,811	1,085,366
Liabilities								
Certificates of Indebtedness	-	-	-	-	-	-	148,406	148,406
Government-issued currency notes and coins in circulation	-	-	-	-	-	-	6,671	6,671
Balance of the banking system	-	-	-	-	-	-	1,561	1,561
Trading liabilities	1,416	5,966	30	-	-	-	-	7,412
Placements by banks and other financial institutions	19,712	6,000	-	-	-	-	-	25,712
Placements by other HKSAR government funds	1,022	460	-	-	-	-	295,604	297,086
Exchange Fund Bills and Notes issued	12,651	32,004	30,022	33,279	10,178	-	-	118,134
Other debt securities issued	1,280	1,906	8,928	11,516	3,446	915	-	27,991
Mortgage-backed securities issued	13	2	1,028	1,919	1,491	692	-	5,145
	36,094	46,338	40,008	46,714	15,115	1,607	452,242	638,118
Liquidity gap	172,314	34,353	17,759	250,729	149,265	40,259	(217,431)	447,248

Exchange Fund - Notes on the Accounts (cont.)

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

	Fund - 2006							Total
	Remaining maturity							
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	Undated or on demand	
Assets								
Cash and money at call	-	-	-	-	-	-	19,661	19,661
Placements with banks and other financial institutions	41,988	778	-	-	-	-	-	42,766
Financial assets designated at fair value through profit or loss	65,080	64,679	141,555	288,600	206,551	42,336	279,391	1,088,192
Available-for-sale securities	-	-	-	-	-	-	493	493
	107,068	65,457	141,555	288,600	206,551	42,336	299,545	1,151,112
Liabilities								
Certificates of Indebtedness	-	-	-	-	-	-	156,926	156,926
Government-issued currency notes and coins in circulation	-	-	-	-	-	-	6,842	6,842
Balance of the banking system	-	-	-	-	-	-	2,035	2,035
Trading liabilities	1,724	372	-	-	-	-	-	2,096
Placements by banks and other financial institutions	7,572	-	-	-	-	-	-	7,572
Placements by other HKSAR government funds	1,000	2,118	-	-	-	-	321,412	324,530
Placements by Hong Kong statutory bodies	-	-	-	-	-	-	26	26
Exchange Fund Bills and Notes issued	14,855	35,568	30,941	36,731	11,044	-	-	129,139
	25,151	38,058	30,941	36,731	11,044	-	487,241	629,166
Liquidity gap	81,917	27,399	110,614	251,869	195,507	42,336	(187,696)	521,946

Exchange Fund - Notes on the Accounts (cont.)

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

	Fund - 2005							Total
	Remaining maturity							
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	Undated or on demand	
Assets								
Cash and money at call	–	–	–	–	–	–	15,887	15,887
Placements with banks and other financial institutions	71,957	1,163	–	–	–	–	–	73,120
Financial assets designated at fair value through profit or loss	132,616	78,134	54,389	280,760	151,737	37,666	217,843	953,145
Available-for-sale securities	–	–	–	–	–	–	493	493
	204,573	79,297	54,389	280,760	151,737	37,666	234,223	1,042,645
Liabilities								
Certificates of Indebtedness	–	–	–	–	–	–	148,406	148,406
Government-issued currency notes and coins in circulation	–	–	–	–	–	–	6,671	6,671
Balance of the banking system	–	–	–	–	–	–	1,561	1,561
Trading liabilities	1,416	5,966	30	–	–	–	–	7,412
Placements by banks and other financial institutions	19,712	6,000	–	–	–	–	–	25,712
Placements by other HKSAR government funds	1,022	460	–	–	–	–	295,604	297,086
Exchange Fund Bills and Notes issued	12,651	32,004	30,022	33,279	10,178	–	–	118,134
	34,801	44,430	30,052	33,279	10,178	–	452,242	604,982
Liquidity gap	169,772	34,867	24,337	247,481	141,559	37,666	(218,019)	437,663

36.3.3 Credit risk

The Fund is exposed to credit risk as a borrower or a counterparty may not be able or willing to perform its contractual obligations in full when due. Credit risk can be broken down into (i) counterparty risk from lending and placement activities; (ii) counterparty risk from derivatives and trading transactions; (iii) issuer risk arising from debt securities holdings; and (iv) country risk. Credit exposures of the Fund are controlled using various credit limits and controls.

Counterparty credit exposures arise mainly from the Group's lending activities, deposit placements with financial institutions, derivatives transactions and repurchase and reverse repurchase agreements. 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 and the size of its total assets and capital. Counterparty credit exposures are measured according to the risk nature of financial products involved in the transaction.

Exchange Fund - Notes on the Accounts (cont.)

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

(a) Maximum exposure to counterparty risk

The maximum exposure to counterparty risk in respect of money at call, placements with financial institutions, derivatives transactions and repurchase and reverse repurchase agreements are represented by their carrying amounts on the balance sheet.

For risk management purposes the Fund will also take into account the potential future credit exposure for derivative financial instruments. Therefore, in addition to the positive mark-to-market replacement value of the derivatives contract, an estimate for the potential future credit exposure of the contract is taken into account when calculating the counterparty credit exposure for risk management purposes.

For the HKMC, the credit risk is primarily attributable to its loan portfolio, which is the risk that a loan borrower will be unable to pay amounts in full when due. Allowance for impairment is provided for losses that have been incurred at the balance sheet date.

Significant changes in the economy and local property market could result in losses that are different from those provided for at the balance sheet date. The HKMC therefore has a prudent policy for managing its exposure to credit risk.

To maintain the asset quality of the loan and mortgage insurance portfolios, the HKMC adheres to a four-pronged approach to (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 or transactions. The HKMC has no significant concentration of credit risk. Risk exposure is spread over a large number of customers, counterparties and a diversified distribution of underlying collateral in Hong Kong.

(b) Maximum exposure to issuer risk

The following table shows issuer credit exposure by credit rating as at 31 December 2006. The issuer credit exposure represents the carrying amount of the debt securities holdings as indicated in notes 9, 10 and 11.

	Group		Fund	
	2006	2005 (restated)	2006	2005 (restated)
Credit rating ¹ of the issuers				
AAA	751,728	667,086	749,717	666,355
AA	33,463	41,296	26,854	36,334
A	20,870	11,830	20,665	11,369
BBB+ and below (including un-rated risk)	31,124	26,995	31,124	26,985
	837,185	747,207	828,360	741,043

¹ the lower of Moody's and Standard and Poor's ratings

Exchange Fund - Notes on the Accounts (cont.)

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

Issuer risk arises from investments in debt securities. Credit limits to 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 qualify as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Fund. The Fund 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 2006, approximately 91% (2005: 90%) of the debt securities held by the Fund were rated "triple-A" by Moody's or Standard and Poor's.

In addition to the counterparty and issuer risk, the Fund is exposed to country risk, which 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 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.

Credit exposure is monitored against the established 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.

Credit exposures of the Fund and its compliance with the established limits are reported regularly to the Credit Review Committee of the HKMA based on its delegated authority from EFAC.

(c) Concentration of credit risk

The following table shows the major concentrations of counterparty credit risk from lending and placement activities at 31 December:

	Group		Fund	
	2006	2005 (restated)	2006	2005
Financial institutions ¹	64,396	91,604	62,427	89,007
Others ²	32,667	33,812	273	263
	97,063	125,416	62,700	89,270

¹ including money at call and placements with banks and other financial institutions

² including mortgage loans, staff housing loans and non-mortgage loans

Counterparty credit risk is diversified as explained in note 36.3.3(a).

Exchange Fund - Notes on the Accounts (cont.)

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

Concentration of counterparty credit risk arising from derivatives activities is limited as all interest rate and currency derivatives are traded with authorised counterparties while futures contracts are transacted through authorised stock exchanges.

The following table shows the issuer credit exposure by industry groups as at 31 December 2006. The issuer credit exposure is the carrying amount of the debt securities as indicated in notes 9, 10 and 11.

	Group		Fund	
	2006	2005 (restated)	2006	2005 (restated)
Governments and government agencies ¹	732,297	646,677	731,951	646,322
Supra-nationals	33,183	34,654	33,103	34,614
States, provinces and public-sector entities ²	5,049	4,502	3,624	3,615
Financial institutions	30,488	29,188	25,224	25,804
Others	36,168	32,186	34,458	30,688
	837,185	747,207	828,360	741,043

¹ including debt securities guaranteed by governments

² including debt securities guaranteed by states

36.3.4 Mortgage insurance risk

To provide mortgage insurance cover to authorized institutions in respect of mortgage loans originated by such authorized institutions and secured by residential properties, the HKMC faces insurance risk of the uncertainty of the insured event occurring and the uncertainty of the amount of the resulting claim.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal risk that the HKMC 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 are greater than estimated. The actual number and amount of claims and benefits will vary year to year from the estimate established using statistical techniques.

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 HKMC 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.

Exchange Fund - Notes on the Accounts (cont.)

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

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 HKMC 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 HKMC calculates technical reserves on prudent liability valuation assumptions and the methods prescribed in the regulatory guidelines. The HKMC 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.

36.3.5 Operational risk

An internal high-level Risk Committee was established in early 2005. 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 assistance for senior management in managing risk in the HKMA's operations.

The HKMA has put in place 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 that may affect the HKMA and the Fund. It also requires the relevant divisions to review the procedures and measures in place to address the identified risks. The assessment and ranking is then 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 is then used as the basis for the annual Internal Audit plan. Internal Audit will audit the risk areas at various frequencies depending on the levels of risks assigned to the areas.

Internal Audit will report its findings to EFAC Audit Sub-Committee and the Chief Executive of the HKMA. It will also follow up on outstanding issues to ensure that they are resolved in a proper manner.

37 FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The fair value of financial instruments traded in active markets is 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, and assuming no change in credit spread where there is no objective evidence of impairment.

The total amount of change in fair value for the Group estimated using a valuation technique that was recognised in the income and expenditure account during the year is HK\$17 million (2005: HK\$17 million).

Exchange Fund - Notes on the Accounts (cont.)

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

The fair values of held-to-maturity securities, and other debt securities and mortgage-backed securities issued that were not designated at fair value through profit or loss, are shown below.

	Group			
	Carrying value		Fair value	
	2006	2005 (restated)	2006	2005 (restated)
Financial assets				
Held-to-maturity securities (note 11)	4,753	4,585	4,714	4,533
Financial liabilities				
Other debt securities issued, not designated at fair value through profit or loss (note 26)	25,929	25,391	25,949	25,398
Mortgage-backed securities issued, not designated at fair value through profit or loss (note 27)	5,341	5,145	5,335	5,135

All other financial instruments of the Group are stated at fair value or carried at amounts not materially different from their fair values as at 31 December 2006 and 2005.

38 NON-ADJUSTING POST BALANCE SHEET EVENT

On 28 February 2007, the Financial Secretary announced a revision of the income-sharing arrangement between the fiscal reserves and the Fund which is currently applicable to placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund (note 24). Under the new scheme, a fixed rate which is determined in January each year will be applied to calculate the fee payable on such placements. The fixed rate will be determined on the basis of either the average rate of return achieved by the investment portfolio of the Fund in the six years immediately before the year in which the fixed rate is to be applied or the average annual yield of three-year Exchange Fund Notes for the previous year, whichever is the higher. This new arrangement will take effect on 1 April 2007 and the fixed rate for 2007 will be 7 per cent.

39 COMPARATIVE FIGURES

Certain comparative figures have been adjusted or reclassified as a result of the changes in accounting policies. Further details are disclosed in note 3.

Exchange Fund - Notes on the Accounts (cont.)

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

40 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2006

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 2006 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 amended disclosures in future financial statements:

	Effective for accounting periods beginning on or after
HKFRS 7, <i>Financial instruments: disclosures</i>	1 January 2007
Amendment to HKAS 1, <i>Presentation of financial statements: capital disclosures</i>	1 January 2007

41 APPROVAL OF ACCOUNTS

The accounts were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 22 March 2007.

Calendar of Events 2006

9 January

The HKMA launches the CMU Bond Price Bulletin website.

23 January

The Treasury Markets Association is established.

14 February

The International Monetary Fund releases its Staff Report giving a positive assessment of Hong Kong's economic performance and commending the Government's fiscal and exchange rate policies.

6 March

The Renminbi Settlement System is launched.

23 March

The HKMA proposes a five-pronged financial development strategy for the maintenance of the status of Hong Kong as an international financial centre.

6-7 June

The People's Bank of China and the HKMA jointly hold a Seminar on Financial Infrastructure in Beijing and Shanghai.

13 June

An Industry Working Group on Prevention of Money Laundering and Terrorist Financing is formed.

3 August

The HKMA releases for public consultation a draft of the Banking (Capital) Rules.

1 September

The HKMA releases for public consultation a draft of the Banking (Disclosure) Rules.

4 September

The Hong Kong banking industry implements a five-day clearing week.

25 September

The Deposit Protection Scheme in Hong Kong starts providing deposit protection. Depositors are protected up to a maximum of \$100,000 of their eligible deposits maintained with Scheme members.

5 October

A review of debt market development in Hong Kong, covering issues related to the Exchange Fund Bills and Notes programme and the three-year rule imposed on Multilateral Development Banks since 1998, is completed.

23 October

The HKMA launches a new bulk settlement service for Hong-Kong-dollar credit-card transactions between banks.

27 October

The Banking (Capital) Rules and Banking (Disclosure) Rules are published in the Gazette.

7 November

The International Monetary Fund commends, in the Concluding Statement made by its 2006 Article IV Consultation Staff Mission to Hong Kong, the Government's efforts in fostering strong market infrastructure and further financial integration with Mainland China.

13 November

The HKMA and Bank Negara Malaysia launch a new cross-border payment-versus-payment link between Hong Kong's US dollar and Malaysia's ringgit RTGS systems.

22 November

The HKMA announces the revisions to the requirements in the HKMA Guideline on prevention of money laundering and terrorist financing relating to wire transfers, giving effect to Special Recommendation VII issued by the Financial Action Task Force on Money Laundering.

1 December

The Legislative Council completes its negative vetting of the Banking (Capital) Rules and Banking (Disclosure) Rules.

14 December

The HKMA and eight credit and debit card scheme operators in Hong Kong launch a Code of Practice for Payment Card Scheme Operators.

Annex and Tables

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Annex: Authorized Institutions and Local Representative Offices at 31.12.2006

Licensed Banks

Incorporated in Hong Kong

Bank of China (Hong Kong) Limited	CITIC Ka Wah Bank Limited	PUBLIC BANK (HONG KONG) LIMITED
Bank of East Asia, Limited (The)	Dah Sing Bank Limited	(formerly known as Asia Commercial Bank Limited)
China Construction Bank (Asia) Corporation Limited (formerly known as Bank of Amercia (Asia) Limited)	DBS BANK (HONG KONG) LIMITED	Shanghai Commercial Bank Limited
CHINA CONSTRUCTION BANK (ASIA) 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 (formerly known as LIU 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
	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 Baroda [#]	CANARA BANK [#]
Agricultural Bank of China	Bank of China Limited	CATHAY UNITED BANK COMPANY, LIMITED
AIG Privat Bank AG [#] also known as: AIG Private Bank Ltd Banque Privée AIG SA Banca Privata AIG SA	Bank of Communications Co., Ltd.	Chang Hwa Commercial Bank Ltd.
Allahabad Bank [#]	Bank of India	Chiba Bank, Ltd. (The)
American Express Bank Limited	Bank of Montreal	China Construction Bank Corporation
Australia and New Zealand Banking Group Limited	Bank of New York (The)	China Merchants Bank Co., Ltd.
BANCA DI ROMA, SOCIETA' PER AZIONI	Bank of Nova Scotia (The)	Chinatrust Commercial Bank, Ltd.
Banca Intesa S.p.A. also known as: Intesa S.p.A.	BANK OF TAIWAN	Chugoku Bank, Ltd. (The)
Banca Monte dei Paschi di Siena S.p.A.	Bank of Tokyo-Mitsubishi UFJ, Ltd. (The) (formerly known as: Bank of Tokyo-Mitsubishi, Ltd. (The))	Citibank, N.A.
Banca Nazionale del Lavoro S.p.A.	BANK SINOPAC	Commerzbank AG
Banco Bilbao Vizcaya Argentaria S.A.	Barclays Bank PLC	Commonwealth Bank of Australia
Bangkok Bank Public Company Limited	Bayerische Hypo- und Vereinsbank Aktiengesellschaft	Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.
Bank of America, National Association	Bayerische Landesbank	Coutts Bank von Ernst AG also known as: Coutts Bank von Ernst SA Coutts Bank von Ernst Ltd
	BNP PARIBAS	Credit Suisse also known as: Crédit Suisse Credito Svizzero Schweizerische Kreditanstalt
	BNP PARIBAS PRIVATE BANK	
	CALYON	
	Canadian Imperial Bank of Commerce	

Annex: Authorized Institutions and Local Representative Offices at 31.12.2006 (cont.)

DBS BANK LTD.	Iyo Bank, Ltd. (The)	Standard Chartered Bank
Deutsche Bank Aktiengesellschaft	JPMorgan Chase Bank, National Association	State Bank of India
DZ BANK AG Deutsche Zentral- Genossenschaftsbank, Frankfurt am Main	KBC Bank N.V.	State Street Bank and Trust Company
E.Sun Commercial Bank, Ltd.	Korea Exchange Bank	Sumitomo Mitsui Banking Corporation
EAST WEST BANK [#]	Land Bank of Taiwan Co., Ltd. [#]	Svenska Handelsbanken AB (publ)
EFG Private Bank SA	Malayan Banking Berhad	TAIPEI FUBON COMMERCIAL BANK CO., LTD.
Equitable PCI Bank, Inc.	MEGA INTERNATIONAL COMMERCIAL BANK CO., LTD. (formerly known as INTERNATIONAL COMMERCIAL BANK OF CHINA CO., LTD. (THE))	TAISHIN INTERNATIONAL BANK CO., LTD
Erste Bank der oesterreichischen Sparkassen AG	MELLI BANK PLC	Taiwan Business Bank
FAR EASTERN INTERNATIONAL BANK	Mitsubishi UFJ Trust and Banking Corporation	Toronto-Dominion Bank (The)
FIMAT INTERNATIONAL BANQUE SA [#]	Mizuho Corporate Bank, Ltd.	UBS AG also known as: UBS SA UBS Ltd
First Commercial Bank, Ltd.	NATIXIS (formerly known as NATEXIS BANQUES POPULAIRES)	UCO Bank
Fortis Bank	National Australia Bank Limited	UniCredito Italiano Societa' per Azioni
Governor and Company of the Bank of Scotland (The)	National Bank of Pakistan	UNITED COMMERCIAL BANK
Hachijuni Bank, Ltd. (The)	Oversea-Chinese Banking Corporation Limited	United Overseas Bank Ltd.
HANA BANK	Philippine National Bank	UTI Bank Limited [#]
HONG LEONG BANK BERHAD	PT. Bank Negara Indonesia (Persero) Tbk.	Wells Fargo Bank, National Association
HSBC BANK INTERNATIONAL LIMITED	Public Bank Berhad	WestLB AG
HSBC Bank plc	Royal Bank of Canada	Westpac Banking Corporation
HSBC Bank USA, National Association	Royal Bank of Scotland public limited company (The)	Woori Bank
HSBC Private Bank (Suisse) SA	SANPAOLO IMI S.p.A.	Deletion in 2006
HSH Nordbank AG	Shiga Bank, Ltd. (The)	Bank Melli Iran
Hua Nan Commercial Bank, Ltd.	Shinkin Central Bank	INTERNATIONAL BANK OF TAIPEI
ICICI BANK LIMITED	Shizuoka Bank, Ltd. (The)	Landesbank Baden-Württemberg
Indian Overseas Bank	Societe Generale	UFJ Bank Limited
Industrial and Commercial Bank of China Limited	SOCIETE GENERALE BANK & TRUST [#]	
ING Bank N.V.		

[#] Addition in 2006

Restricted Licence Banks

Incorporated in Hong Kong

AIG Finance (Hong Kong) Limited
ALLIED BANKING CORPORATION
(HONG KONG) LIMITED
Banc of America Securities Asia
Limited
Bank of Baroda (Hong Kong)
Limited
BOCI Capital Limited
Citicorp International Limited
GE Capital (Hong Kong) Limited
Indover bank (Asia) Limited

Industrial and Commercial
International Capital Limited
J.P. MORGAN SECURITIES (ASIA
PACIFIC) LIMITED
KDB Asia Limited
KOOKMIN BANK HONG KONG
LIMITED
Mitsubishi UFJ Securities (HK)
Capital, Limited
ORIX Asia Limited

SCOTIABANK (HONG KONG)
LIMITED
Shinhan Finance Limited
Societe Generale Asia Limited
UBAF (Hong Kong) Limited

Deletion in 2006

ABSA BANK (ASIA) LIMITED
Pacific Finance (Hong Kong)
Limited

Incorporated outside Hong Kong

Bank of Ayudhya Public
Company Limited
CIMB BANK BERHAD
(formerly known as Bumiputra-
Commerce Bank Berhad)
Credit Agricole (Suisse) SA#
Industrial Bank of Korea
Lloyds TSB Bank Plc
Mashreq Bank – Public
Shareholding Company
also known as:
Mashreqbank psc

PT. BANK MANDIRI (PERSERO)
Tbk
RBC Dexia Investor Services Bank
S.A.
(Licence transfer from Dexia
Banque Internationale à
Luxembourg)
Shinhan Bank#
Siam Commercial Bank Public
Company Limited (The)

Thanakharn Kasikorn Thai
Chamkat (Mahachon)
also known as:
KASIKORNBANK PUBLIC
COMPANY LIMITED
TMB Bank Public Company
Limited
Wachovia Bank, National
Association

Deletion in 2006

HYPO REAL ESTATE BANK
INTERNATIONAL
Union Bank of California,
National Association

Addition in 2006

Annex: Authorized Institutions and Local Representative Offices at 31.12.2006 (cont.)

Deposit-taking Companies

Incorporated in Hong Kong

Argo Enterprises Company Limited	Gunma Finance (Hong Kong) Limited	OCTOPUS CARDS LIMITED
BCOM Finance (Hong Kong) Limited	Habib Finance International Limited	Orient First Capital Limited
BII Finance Company Limited	Hachijuni Asia Limited	PrimeCredit Limited
BPI International Finance Limited	HBZ Finance Limited	SHINHAN ASIA LIMITED (formerly known as Chohung Finance Limited)
Chau's Brothers Finance Company Limited	Henderson International Finance Limited	Sumitomo Trust Finance (H.K.) Limited (The)
Chong Hing Finance Limited (formerly known as: Liu Chong Hing Finance Limited)	HKCB Finance Limited	Vietnam Finance Company Limited
Commonwealth Finance Corporation Limited	Hung Kai Finance Company Limited	Wing Hang Finance Company Limited
Corporate Finance (D.T.C.) Limited	Inchroy Credit Corporation Limited	Wing Lung Finance Limited
Delta Asia Credit Limited	Indo Hong Kong International Finance Limited	WOORI GLOBAL MARKETS ASIA LIMITED [#]
Edward Wong Credit Limited	PUBLIC FINANCE LIMITED (formerly known as: JCG Finance Company, Limited)	Deletion in 2006
First Metro International Investment Company Limited	KEXIM ASIA LIMITED	Shacom Finance Limited
FUBON CREDIT (HONG KONG) LIMITED	Michinoku Finance (Hong Kong) Limited	

Incorporated outside Hong Kong

NIL

Local Representative Offices

ANTWERPSE DIAMANTBANK NV also known as: ANTWERP DIAMOND BANK NV	Banca Popolare di Ancona Società per azioni	Banco de Crédito e Inversiones
Arab Bank plc	Banca Popolare di Bergamo S.p.A.	Banco do Brasil S.A.
Banca del Gottardo	Banca Popolare di Novara – Società per Azioni	Banco Popolare di Verona e Novara S.c.r.l.
BANCA POPOLARE COMMERCIO E INDUSTRIA SPA [#]	Banca Popolare di Sondrio Soc. Coop. a r.l.	Banco Popular Español, S.A.
Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l.	Banca Popolare di Vicenza Soc. Coop. a r.l.	Banco Santander Central Hispano, S.A.
	Banche Popolari Unite Società Cooperativa per azioni [#]	Bank Hapoalim (Switzerland) Ltd
		Bank Julius Baer & Co. Ltd. [#]
		Bank Leumi Le-Israel B.M.

[#] Addition in 2006

Bank of Fukuoka, Ltd. (The)	HSBC Bank Australia Limited	Rothschild Bank AG
Bank of Kyoto, Ltd. (The)	HSBC Bank Canada	Schroder & Co Bank AG
Bank of Yokohama, Ltd. (The)	HSBC Guyerzeller Bank AG	also known as:
Banque Piguet & Cie S.A.#	HSBC Trinkaus & Burkhardt (International) S.A.	Schroder & Co Banque SA
Banque Privee Edmond de Rothschild S.A.	HSB Nordbank Private Banking S.A.	Schroder & Co Banca SA
BARCLAYS BANK (SUISSE) S.A.	Investec Bank Limited	Schroder & Co Bank Ltd
BSI Ltd.	Japan Bank for International Cooperation	Schroder & Co Banco SA
CARIPRATO – Cassa di Risparmio di Prato S.p.A.	Juroku Bank, Ltd. (The)	Shanghai Pudong Development Bank Co., Ltd.
Cathay Bank	Kagoshima Bank Ltd. (The)	Shenzhen Development Bank Co., Ltd.
China Development Bank	Korea Development Bank (The)	Shoko Chukin Bank (The)
China Everbright Bank Co., Ltd	Kredietbank S.A. Luxembourgeoise	Standard Bank of South Africa Ltd. (The)
CHINA MINSHENG BANKING CORPORATION LIMITED	LGT Bank in Liechtenstein AG also known as:	STANDARD CHARTERED (JERSEY) LIMITED
Chinese Bank (The)	LGT Bank in Liechtenstein Ltd.	Taiwan Cooperative Bank
CITIC Group	LGT Banque de Liechtenstein S.A.	Union Bank of Taiwan
Clariden Bank	LGT Banca di Liechtenstein S.A.	Veneto Banca S.c.a.r.l.
CLEARSTREAM BANKING S.A.	LLOYDS TSB OFFSHORE LIMITED	Verwaltungs- und Privat-Bank Aktiengesellschaft#
Credit Industriel et Commercial	Merrill Lynch Bank (Suisse) S.A.	Yamaguchi Bank, Ltd. (The)
Credito Bergamasco S.p.A.	Metropolitan Bank and Trust Company	Yamanashi Chuo Bank, Ltd.
D.A.H. Hambros Bank (Channel Islands) Limited	Nanto Bank, Ltd. (The)	Deletion in 2006
DePfa Investment Bank Limited	National Bank of Canada	AIG Private Bank Ltd.
DVB Bank N.V.	Nishi-Nippon Bank, Ltd. (The)	Banca Antoniana-Popolare Veneta S.C.A R.L.
eBANK Corporation	Norinchukin Bank (The)	Bank für Arbeit und Wirtschaft Aktiengesellschaft
Euroclear Bank	Ogaki Kyoritsu Bank, Ltd. (The)	Bank of New York – Inter Maritime Bank, Geneva
Fiduciary Trust Company International	Oita Bank, Ltd. (The)	Barclays Private Clients International Limited#
Fuhwa Commercial Bank Co., Ltd.	P.T. Bank Central Asia	Land Bank of Taiwan
GUANGDONG DEVELOPMENT BANK CO., LTD.	P.T. Bank Rakyat Indonesia (Persero)	Merrill Lynch International Bank Limited
Habib Bank A.G. Zurich	Raiffeisen Zentralbank Österreich AG	UFJ Bank (Schweiz) AG
	Resona Bank, Limited	also known as:
		UFJ Bank (Switzerland) Ltd.
		UFJ Banque (Suisse) SA
		UFJ Banca (Svizzera) SA

Table A: Major Economic Indicators

	2002	2003	2004	2005	2006
I. Gross Domestic Product					
Real GDP growth (%)	1.8	3.2	8.6	7.5	6.8 ^(a)
Nominal GDP growth (%)	-1.7	-3.4	4.7	7.1	6.5 ^(a)
Real growth of major expenditure components of GDP (%)					
– Private consumption expenditure	-1.0	-0.9	7.2	3.3	5.1 ^(a)
– Government consumption expenditure	2.5	1.9	0.7	-3.1	0.3 ^(a)
– Gross domestic fixed capital formation of which	-4.5	0.9	3.1	4.6	7.9 ^(a)
– Building and construction	-1.1	-5.6	-11.6	-8.4	-7.2 ^(a)
– Machinery, equipment and computer software	-7.6	6.7	11.0	12.9	17.2 ^(a)
– Exports	9.1	13.1	15.8	11.2	9.9 ^(a)
– Imports	7.5	11.5	14.2	8.5	9.7 ^(a)
GDP at current market prices (US\$ billion)	163.7	158.5	165.8	177.8	189.5 ^(a)
Per capita GDP at current market prices (US\$)	24,274	23,544	24,445	26,096	27,640 ^(a)
II. External Trade (HK\$ billion)					
Merchandise trade ^(b)					
– Domestic exports of goods	131.1	122.1	126.4	136.3	138.8 ^(a)
– Re-exports of goods	1,431.0	1,627.0	1,900.6	2,115.4	2,328.6 ^(a)
– Total imports of goods	1,601.5	1,794.1	2,099.5	2,311.1	2,576.3 ^(a)
– Merchandise trade balance	-39.4	-45.0	-72.5	-59.3	-109.0 ^(a)
Services trade					
– Exports of services	347.8	362.4	429.6	495.8	562.3 ^(a)
– Imports of services	202.5	203.4	242.5	264.2	283.9 ^(a)
– Services trade balance	145.3	159.0	187.1	231.6	278.4 ^(a)
III. Fiscal Expenditure and Revenue (HK\$ million, fiscal year)					
Total government expenditure	239,177	247,466	242,235	233,071	232,991 ^(a)
Total government revenue	177,489	207,338	263,591	247,035	288,075 ^(a)
Consolidated surplus/deficit	-61,688	-40,128	21,356	13,964	55,084 ^(a)
Reserve balance as at end of fiscal year ^(c)	311,402	275,343	295,981	310,663	365,747 ^(a)
IV. Prices (annual change, %)					
Consumer Price Index (A)	-3.2	-2.1	0.0	1.1	1.7
Composite Consumer Price Index	-3.0	-2.6	-0.4	1.0	2.0
Trade Unit Value Indices					
– Domestic exports	-3.3	0.2	1.5	2.2	-2.1
– Re-exports	-2.7	-1.5	1.1	1.2	1.1
– Imports	-3.9	-0.4	2.9	2.7	2.1
Property Price Indices					
– Residential flats	-11.2	-11.9	26.6	17.9	0.7 ^(a)
– Office premises	-13.1	-8.6	58.9	33.9	4.5 ^(a)
– Retail premises	-2.1	0.6	39.5	25.1	2.3 ^(a)
– Flatted factory premises	-8.8	-4.1	23.6	41.1	26.3 ^(a)

	2002	2003	2004	2005	2006
V. Labour					
Labour force (annual change, %)	1.4	0.0	1.3	0.6	1.3
Employment (annual change, %)	-1.0	-0.7	2.5	2.0	2.1
Unemployment rate (annual average, %)	7.3	7.9	6.8	5.6	4.8
Underemployment rate (annual average, %)	3.0	3.5	3.2	2.7	2.4
Employment ('000) of which	3,220	3,197	3,277	3,341	3,412
– Manufacturing	287	268	231	224	218
– Financing, insurance, real estate and business services	478	472	482	506	526
– Wholesale, retail and import/export trades, restaurants and hotels	978	985	1,064	1,094	1,109
VI. Money Supply (HK\$ billion)					
HK\$ money supply					
– M1	259.4	354.8	412.6	348.2	387.9
– M2 ^(d)	1,984.0	2,107.3	2,208.6	2,329.7	2,777.8
– M3 ^(d)	2,004.2	2,122.9	2,219.6	2,345.8	2,795.7
Total money supply					
– M1	295.6	413.4	484.5	434.7	491.7
– M2	3,518.3	3,813.4	4,166.7	4,379.1	5,063.3
– M3	3,561.9	3,858.0	4,189.5	4,407.2	5,098.7
VII. Interest Rates (end of period, %)					
Three-month interbank rate	1.41	0.07	0.28	4.16	3.84
Savings deposit	0.03	0.01	0.01	2.32	2.26
One-month time deposit	0.13	0.01	0.02	2.68	2.52
Banks' 'Best lending rate'	5.00	5.00	5.00	7.75	7.75
Banks' 'Composite rate'	N.A.	0.24	0.30	2.88	2.86
VIII. Exchange Rates (end of period)					
HK\$/US\$	7.798	7.763	7.774	7.753	7.775
Trade-weighted Effective Exchange Rate Index (Jan 2000=100)	102.0	98.8	96.0	98.4	94.3
IX. Foreign Currency Reserve Assets (US\$ billion) ^(e)					
	111.9	118.4	123.6	124.3	133.2
X. Stock Market (end of period figures)					
Hang Seng Index	9,321	12,576	14,230	14,876	19,965
Average price/earning ratio	14.9	19.0	18.7	15.6	17.4
Market capitalisation (HK\$ billion)	3,559.1	5,477.7	6,629.2	8,113.3	13,248.8

(a) The estimates are preliminary.

(b) Includes non-monetary gold.

(c) Includes changes in provision for loss in investments with the Exchange Fund.

(d) Adjusted to include foreign currency swap deposits.

(e) Excludes unsettled forward transactions but includes gold.

N.A. Not Applicable

Table B: Performance Ratios of the Banking Sector ^(a)

	2002	2003	All AIs 2004	2005	2006
Asset Quality ^(b)	%	%	%	%	%
As % of total credit exposures ^(c)					
Total outstanding provisions/ impairment allowances	1.40	1.14	0.78	0.49	0.39
Classified ^(d) exposures:					
Gross	2.77	2.25	1.22	0.81	0.59
Net of specific provisions/ individual impairment allowances	1.85	1.54	0.81	0.54	0.41
Net of all provisions/impairment allowances	1.37	1.10	0.44	0.33	0.21
As % of total loans					
Total outstanding provisions/ impairment allowances	2.39	1.98	1.42	0.87	0.71
Classified ^(d) loans:					
Gross	4.53	3.74	2.11	1.34	1.05
Net of specific provisions/ individual impairment allowances	2.98	2.54	1.40	0.87	0.73
Net of all provisions/impairment allowances	2.13	1.76	0.70	0.47	0.34
Overdue > 3 months and rescheduled loans	3.41	2.81	1.54	0.94	0.76
Profitability					
Return on assets (operating profit)	0.94	0.93	1.06	1.07	1.13
Return on assets (post-tax profit)	0.81	0.81	0.97	0.97	1.00
Net interest margin	1.52	1.41	1.18	1.18	1.29
Cost-income ratio	46.3	45.8	48.7	50.4	50.8
Bad debt charge to total assets	0.24	0.24	0.01	0.01	0.03
Liquidity					
Loan to deposit ratio (all currencies)	62.6	57.1	55.8	56.8	51.8
Loan to deposit ^(e) ratio (Hong Kong dollar)	88.5	81.5	82.6	84.3	74.7

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)

(a) Figures are related to HK office(s) only except where otherwise stated.

(b) Figures are related to HK office(s). For locally incorporated AIs, figures include their overseas branches.

(c) Credit exposures include loans & advances, acceptances & 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.

Retail banks				
2002	2003	2004	2005	2006
%	%	%	%	%
1.41	1.13	0.77	0.42	0.33
3.02	2.32	1.27	0.82	0.63
2.15	1.67	0.91	0.60	0.48
1.61	1.18	0.50	0.39	0.30
2.49	2.05	1.45	0.78	0.63
5.04	3.94	2.25	1.37	1.11
3.53	2.78	1.59	0.98	0.85
2.55	1.89	0.80	0.59	0.48
3.59	2.87	1.48	0.92	0.80
1.35	1.36	1.52	1.55	1.53
1.18	1.18	1.39	1.40	1.35
2.09	1.91	1.66	1.68	1.80
39.3	38.6	41.4	41.8	42.7
0.34	0.29	-0.02	-0.01	0.01
53.5	49.5	50.0	53.2	47.9
78.6	71.6	73.2	78.8	69.1

Surveyed Institutions				
2002	2003	2004	2005	2006
%	%	%	%	%
1.06	0.86	0.38	0.19	0.20
1.28	0.92	0.44	0.37	0.37
13.25	10.02	4.73	2.81	2.91

Locally incorporated banks				
2002	2003	2004	2005	2006
%	%	%	%	%
16.2	16.9	18.7	18.4	18.9
14.0	14.6	17.2	16.7	16.6
10.6	10.5	10.6	8.1	8.2

All locally incorporated AIs				
2002	2003	2004	2005	2006
%	%	%	%	%
15.7	15.3	15.4	14.8	15.0

Table C: Authorized Institutions: Domicile and Parentage

	2002	2003	2004	2005	2006
Licensed Banks					
(i) Incorporated in Hong Kong	26	23	24	24	24
(ii) Incorporated outside Hong Kong	107	111	109	109	114
Total	133	134	133	133	138
Restricted Licence Banks					
(i) Subsidiaries of licensed banks :					
(a) incorporated in Hong Kong	2	1	1	0	0
(b) incorporated outside Hong Kong	12	11	10	8	8
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	26	24	23	21	20
(iii) Bank related	3	3	3	1	0
(iv) Others	3	3	3	3	3
Total	46	42	40	33	31
Deposit-taking Companies					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	14	9	7	6	5
(b) incorporated outside Hong Kong	4	3	2	2	3
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	15	15	14	13	13
(iii) Bank related	2	2	2	3	3
(iv) Others	10	10	10	9	9
Total	45	39	35	33	33
All Authorized Institutions	224	215	208	199	202
Local Representative Offices	94	87	85	86	84

Table D: Authorized Institutions: Region/Economy of Beneficial Ownership

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	02	03	04	05	06	02	03	04	05	06	02	03	04	05	06
Asia & Pacific															
Hong Kong	12	13	12	12	11	2	1	1	1	–	14	13	12	11	10
Australia	4	4	4	4	4	–	–	–	–	–	–	–	–	–	–
Mainland China	13	12	13	12	13	2	2	2	2	2	3	3	2	2	2
India	4	4	4	5	9	1	1	1	1	1	2	2	2	2	2
Indonesia	1	1	1	1	1	2	2	2	2	2	2	2	1	1	1
Japan	15	13	12	12	11	4	4	4	3	2	7	5	4	4	4
Malaysia	1	2	3	3	4	2	1	1	1	1	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	3	3
Singapore	6	4	4	4	4	–	–	–	–	–	2	–	–	–	–
South Korea	3	3	3	3	3	5	5	4	4	5	1	1	2	2	3
Taiwan	10	13	14	15	15	2	–	–	–	–	–	–	1	1	1
Thailand	1	1	1	1	1	4	4	4	4	4	–	–	–	–	–
Vietnam	–	–	–	–	–	–	–	–	–	–	1	1	1	1	1
Sub-Total	73	73	74	75	79	25	21	20	19	18	38	33	31	30	30
Europe															
Austria	1	1	1	1	1	–	–	–	–	–	–	–	–	–	–
Belgium	3	3	2	2	2	–	–	–	–	–	–	–	–	–	–
Denmark	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
France	6	6	6	5	7	3	2	2	2	3	–	–	–	–	–
Germany	9	9	8	8	7	–	–	1	1	–	–	–	–	–	–
Italy	6	6	6	6	6	–	–	–	–	–	–	–	–	–	–
Netherlands	3	3	3	3	3	–	–	–	–	–	–	–	–	–	–
Spain	1	1	1	1	1	–	–	–	–	–	–	–	–	–	–
Sweden	1	1	1	1	1	–	–	–	–	–	–	–	–	–	–
Switzerland	3	3	3	3	3	1	1	1	–	–	–	–	–	–	–
United Kingdom	10	9	10	10	10	2	2	1	1	1	–	–	–	–	–
Sub-Total	43	42	41	40	41	6	5	5	4	4	–	–	–	–	–
Middle East															
Bahrain	1	1	–	–	–	–	–	–	–	–	1	1	–	–	–
Iran	1	1	1	2	1	–	–	–	–	–	–	–	–	–	–
U.A.E.	–	–	–	–	–	–	1	1	1	1	1	1	–	–	–
Sub-Total	2	2	1	2	1	–	1	1	1	1	2	2	–	–	–
North America															
Canada	4	5	5	5	5	2	2	2	1	1	–	–	–	–	–
United States	10	11	11	10	11	9	9	8	6	6	3	3	3	2	2
Sub-Total	14	16	16	15	16	11	11	10	7	7	3	3	3	2	2
South Africa	1	1	1	1	1	2	2	2	1	–	1	–	–	–	–
Bermuda	–	–	–	–	–	2	1	1	–	–	–	–	–	–	–
Others	–	–	–	–	–	–	1	1	1	1	1	1	1	1	1
Grand Total	133	134	133	133	138	46	42	40	33	31	45	39	35	33	33

Table E: Presence of World's Largest 500 Banks in Hong Kong

Positions at 31.12.2006	Number of Overseas Banks ^(b)					Licensed Banks ^(c)				
	02	03	04	05	06	02	03	04	05	06
World Ranking ^(a)										
1-20	20	20	20	19	20	30	30	33	28	33
21-50	23	23	22	25	23	22	21	19	25	23
51-100	30	32	28	27	26	27	27	23	23	21
101-200	42	44	42	39	37	21	22	22	19	20
201-500	53	51	45	47	50	15	18	17	22	25
Sub-total	168	170	157	157	156	115	118	114	117	122
Others	51	44	52	51	55	18	16	19	16	16
Total	219	214	209	208	211	133	134	133	133	138

(a) Top 500 banks/banking groups in the world ranked by total assets less contra items. Figures are extracted from The Banker, July 2006 issue.

(b) The sum of the number of licensed banks, restricted licence banks, deposit-taking companies and local representative offices is greater than the number of overseas banks with a presence in Hong Kong because of the multiple presence of some overseas banks.

(c) Consist of branches and subsidiaries of overseas banks.

Restricted Licence Banks ^(c)						Deposit-Taking Companies ^(c)					Local Representative Offices				
02	03	04	05	06		02	03	04	05	06	02	03	04	05	06
12	11	10	5	5		4	3	1	1	1	7	7	7	8	8
3	4	5	5	5		–	–	–	–	–	7	4	4	5	5
4	4	4	4	4		5	2	2	3	5	6	6	5	5	7
2	3	3	2	1		5	5	4	3	3	19	23	22	21	19
13	10	7	5	5		8	7	5	3	3	24	22	20	21	22
34	32	29	21	20		22	17	12	10	12	63	62	58	60	61
12	10	11	12	11		23	22	23	23	21	31	25	27	26	23
46	42	40	33	31		45	39	35	33	33	94	87	85	86	84

Table F: Balance Sheet: All Authorized Institutions and Retail Banks

All Authorized Institutions

(HK\$ bn)

	2002		
	HK\$	F/CY	Total
Assets			
Loans to customers	1,616	461	2,076
Inside Hong Kong ^(a)	1,591	243	1,834
Outside Hong Kong ^(b)	25	218	243
Interbank lending	332	1,983	2,315
Inside Hong Kong	236	159	395
Outside Hong Kong	96	1,823	1,919
Negotiable certificates of deposit (NCD)	90	44	134
Negotiable debt instruments, other than NCD	395	715	1,109
Other assets	255	110	365
Total assets	2,687	3,312	5,999

Liabilities

Deposits from customers ^(c)	1,825	1,493	3,318
Interbank borrowing	384	1,404	1,788
Inside Hong Kong	236	157	394
Outside Hong Kong	147	1,246	1,394
Negotiable certificates of deposit	138	73	211
Other liabilities	509	173	683
Total liabilities	2,856	3,143	5,999

Retail Banks

(HK\$ bn)

	2002		
	HK\$	F/CY	Total
Assets			
Loans to customers	1,307	151	1,459
Inside Hong Kong ^(a)	1,296	130	1,426
Outside Hong Kong ^(b)	11	22	33
Interbank lending	245	765	1,010
Inside Hong Kong	190	107	297
Outside Hong Kong	56	658	713
Negotiable certificates of deposit (NCD)	61	21	82
Negotiable debt instruments, other than NCD	259	484	744
Other assets	208	61	269
Total assets	2,081	1,483	3,564
Liabilities			
Deposits from customers ^(c)	1,663	1,063	2,726
Interbank borrowing	78	213	291
Inside Hong Kong	24	31	55
Outside Hong Kong	54	182	236
Negotiable certificates of deposit	86	52	138
Other liabilities	365	44	409
Total liabilities	2,193	1,372	3,564

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

2003			2004			2005			2006		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,573	462	2,035	1,667	489	2,156	1,797	515	2,312	1,917	550	2,468
1,542	267	1,809	1,631	291	1,923	1,749	323	2,072	1,832	295	2,127
31	195	226	36	198	233	48	192	240	85	255	341
438	2,175	2,614	447	2,577	3,024	433	2,457	2,890	647	2,802	3,449
295	177	472	291	185	476	227	182	410	304	198	502
144	1,998	2,142	156	2,392	2,548	206	2,275	2,481	343	2,604	2,947
86	58	144	74	48	121	66	32	97	60	43	103
397	800	1,197	459	870	1,328	437	934	1,371	536	1,082	1,617
289	212	501	296	212	508	314	263	577	346	324	670
2,783	3,708	6,491	2,943	4,195	7,138	3,047	4,200	7,247	3,506	4,800	8,307
1,931	1,636	3,567	2,018	1,848	3,866	2,132	1,936	4,068	2,568	2,198	4,766
428	1,489	1,918	439	1,711	2,150	412	1,555	1,967	516	1,738	2,254
285	185	470	296	203	499	231	184	416	306	203	509
143	1,305	1,448	143	1,508	1,651	180	1,371	1,551	210	1,535	1,745
132	110	242	124	132	256	131	132	263	129	110	240
495	268	764	609	256	865	624	325	949	678	369	1,047
2,987	3,504	6,491	3,191	3,947	7,138	3,299	3,948	7,247	3,892	4,415	8,307
2003			2004			2005			2006		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,278	172	1,450	1,371	200	1,571	1,510	215	1,725	1,577	218	1,794
1,266	146	1,412	1,354	159	1,513	1,483	160	1,643	1,529	148	1,677
12	26	39	17	41	58	27	56	83	48	70	118
330	836	1,166	302	1,022	1,324	266	982	1,247	425	1,023	1,449
247	110	358	235	117	352	175	101	276	245	103	348
83	726	809	67	905	972	91	881	972	180	920	1,100
58	38	96	55	28	83	50	20	71	44	16	59
278	565	843	317	583	900	316	640	955	422	755	1,177
233	78	312	244	99	343	241	121	362	279	166	446
2,178	1,689	3,867	2,289	1,932	4,220	2,383	1,978	4,361	2,747	2,178	4,925
1,786	1,141	2,927	1,874	1,270	3,144	1,916	1,326	3,242	2,283	1,466	3,749
90	265	354	89	295	384	102	264	366	113	228	341
31	26	58	38	30	68	58	38	95	49	35	84
58	238	296	51	265	316	45	226	271	65	193	258
82	80	162	80	99	179	85	97	182	76	83	159
361	63	424	434	79	513	462	109	571	538	139	676
2,319	1,548	3,867	2,477	1,743	4,220	2,565	1,796	4,361	3,010	1,915	4,925

Table G: Major Balance Sheet Items by Region/Economy of Beneficial Ownership of Authorized Institutions

(HK\$ bn)

		Mainland China	Japan	US	Europe	Others	Total
Total Assets	2005	1,182	550	681	1,803	3,031	7,247
	2006	1,383	590	728	2,112	3,494	8,307
Deposits from Customers	2005	842	155	315	642	2,114	4,068
	2006	1,017	159	345	786	2,459	4,766
Loans to Customers	2005	510	134	139	420	1,108	2,312
	2006	571	149	129	454	1,165	2,468
Loans to Customers Inside Hong Kong ^(a)	2005	468	102	130	331	1,041	2,072
	2006	489	112	116	335	1,076	2,127
Loans to Customers Outside Hong Kong ^(b)	2005	42	32	9	89	67	240
	2006	83	37	13	119	89	341

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

Figures may not add up to total due to rounding.

Table H: Flow of Funds for All Authorized Institutions and Retail Banks

All Authorized Institutions

(HK\$ bn)

Increase/(Decrease) in	2005			2006		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	131	26	156	120	36	156
Inside Hong Kong ^(a)	118	31	149	83	(28)	55
Outside Hong Kong ^(b)	13	(6)	7	37	64	101
Interbank lending	(14)	(120)	(134)	213	345	558
Inside Hong Kong	(64)	(2)	(66)	76	16	92
Outside Hong Kong	50	(118)	(68)	137	330	466
All other assets	(13)	99	87	126	219	346
Total assets	104	5	109	460	600	1,060
Liabilities						
Deposits from customers ^(c)	114	88	202	437	261	698
Interbank borrowing	(28)	(156)	(183)	104	183	287
Inside Hong Kong	(65)	(19)	(83)	75	18	93
Outside Hong Kong	37	(137)	(100)	29	164	194
All other liabilities	22	69	91	53	22	75
Total liabilities	108	1	109	594	466	1,060
Net interbank borrowing/(lending)	(14)	(36)	(50)	(109)	(163)	(271)
Net customer lending/(borrowing)	17	(63)	(46)	(317)	(226)	(542)

Retail Banks

(HK\$ bn)

Increase/(Decrease) in	2005			2006		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	139	16	155	67	3	69
Inside Hong Kong ^(a)	129	1	130	46	(12)	34
Outside Hong Kong ^(b)	10	15	25	21	14	35
Interbank lending	(36)	(40)	(76)	160	41	201
Inside Hong Kong	(60)	(16)	(76)	71	2	72
Outside Hong Kong	24	(24)	(0)	89	40	129
All other assets	(8)	71	62	138	156	294
Total assets	94	47	141	364	200	564
Liabilities						
Deposits from customers ^(c)	42	56	98	367	140	507
Interbank borrowing	13	(32)	(18)	11	(36)	(25)
Inside Hong Kong	20	7	27	(9)	(3)	(12)
Outside Hong Kong	(6)	(39)	(45)	20	(33)	(13)
All other liabilities	33	28	61	67	15	82
Total liabilities	88	53	141	445	119	564
Net interbank borrowing/(lending)	50	8	58	(149)	(77)	(226)
Net customer lending/(borrowing)	97	(41)	56	(301)	(137)	(438)

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

Table I: Loans to and Deposits from Customers by Category of Authorized Institutions

(HK\$ bn)

	Loans to Customers				Deposits from Customers ^(a)			
	HK\$	F/CY	Total	%	HK\$	F/CY	Total	%
2002								
Licensed banks	1,491	446	1,937	93	1,806	1,470	3,276	99
Restricted licence banks	99	13	112	5	15	21	36	1
Deposit-taking companies	26	2	27	1	4	2	6	—
Total	1,616	461	2,076	100	1,825	1,493	3,318	100
2003								
Licensed banks	1,465	448	1,913	94	1,916	1,608	3,524	99
Restricted licence banks	85	12	97	5	12	27	38	1
Deposit-taking companies	24	1	25	1	3	2	5	—
Total	1,573	462	2,035	100	1,931	1,636	3,567	100
2004								
Licensed banks	1,581	475	2,057	95	2,007	1,839	3,846	99
Restricted licence banks	67	12	79	4	8	7	15	—
Deposit-taking companies	19	2	21	1	3	2	5	—
Total	1,667	489	2,156	100	2,018	1,848	3,866	100
2005								
Licensed banks	1,750	500	2,250	97	2,116	1,927	4,043	99
Restricted licence banks	26	13	39	2	12	7	19	—
Deposit-taking companies	22	1	23	1	3	2	5	—
Total	1,797	515	2,312	100	2,132	1,936	4,068	100
2006								
Licensed banks	1,870	532	2,402	97	2,552	2,183	4,734	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	2,198	4,766	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 due to rounding.

Table J: Loans to Customers Inside Hong Kong by Economic Sector

All Authorized institutions

(HK\$ bn)

Sector	2002		2003		2004		2005		2006	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	91	5	100	6	130	7	142	7	152	7
Manufacturing	71	4	80	4	99	5	119	6	104	5
Transport & transport equipment	104	6	110	6	121	6	123	6	123	6
Building, construction & property development and investment	379	21	360	20	386	20	451	22	492	23
Wholesale and retail trade	100	5	94	5	99	5	101	5	105	5
Financial concerns (other than authorized institutions)	125	7	147	8	168	9	179	9	185	9
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	99	5	87	5	77	4	68	3	60	3
to purchase other residential property	542	30	529	29	534	28	539	26	535	25
other purposes	143	8	137	8	149	8	169	8	183	9
Others	178	10	164	9	158	8	183	9	188	9
Total ^(a)	1,834	100	1,809	100	1,923	100	2,072	100	2,127	100

Retail banks

(HK\$ bn)

Sector	2002		2003		2004		2005		2006	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	72	5	80	6	103	7	115	7	124	7
Manufacturing	47	3	53	4	65	4	75	5	68	4
Transport & transport equipment	63	4	68	5	76	5	81	5	82	5
Building, construction & property development and investment	311	22	301	21	331	22	378	23	397	24
Wholesale and retail trade	70	5	65	5	67	4	69	4	73	4
Financial concerns (other than authorized institutions)	56	4	65	5	65	4	70	4	76	5
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	65	5	57	4	51	3	68	4	60	4
to purchase other residential property	508	36	501	35	515	34	526	32	522	31
other purposes	111	8	104	7	126	8	140	9	152	9
Others	122	9	117	8	113	7	120	7	122	7
Total ^(a)	1,426	100	1,412	100	1,513	100	1,643	100	1,677	100

(a) Defined as loans for use in Hong Kong plus trade financing loans.
Figures may not add up to total due to rounding.

Table K: Deposits from Customers

(HK\$ bn)	All Authorized Institutions				Retail banks			
	Demand	Savings	Time	Total	Demand	Savings	Time	Total
Hong Kong Dollar ^(a)								
2002	146	674	1,004	1,825	134	668	861	1,663
2003	227	936	768	1,931	203	927	656	1,786
2004	272	1,033	713	2,018	250	1,023	601	1,874
2005	206	742	1,183	2,132	190	734	992	1,916
2006	238	933	1,397	2,568	219	924	1,140	2,283
Foreign Currency								
2002	36	272	1,184	1,493	24	245	794	1,063
2003	59	341	1,236	1,636	38	307	796	1,141
2004	72	399	1,378	1,848	47	357	866	1,270
2005	86	402	1,448	1,936	56	353	917	1,326
2006	104	426	1,668	2,198	70	373	1,024	1,466
Total								
2002	182	946	2,189	3,318	158	913	1,656	2,726
2003	286	1,278	2,004	3,567	241	1,234	1,452	2,927
2004	344	1,432	2,090	3,866	297	1,379	1,468	3,144
2005	292	1,144	2,631	4,068	246	1,087	1,909	3,242
2006	341	1,359	3,066	4,766	289	1,297	2,164	3,749

(a) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

Table L: Geographical Breakdown of Net External Claims/(Liabilities) of All Authorized Institutions

(HK\$ bn) Region/Economy	2005			2006		
	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 & Pacific	532	(159)	373	697	(199)	497
Australia	186	24	210	275	37	312
Singapore	299	(53)	246	329	(79)	250
South Korea	57	20	76	189	21	210
Japan	84	23	107	(34)	65	31
India	10	6	16	5	9	14
Malaysia	(5)	12	7	0	11	10
New Zealand	10	2	12	3	0	3
Maldives	0	0	0	1	0	1
Sri Lanka	1	0	1	1	0	1
Bangladesh	1	0	1	1	0	1
Republic of Kazakhstan	1	0	1	1	0	1
Laos	0	(1)	(1)	0	0	0
Pakistan	(1)	0	0	0	0	0
Vanuatu	0	(1)	(1)	0	(1)	(1)
Vietnam	0	0	0	(4)	0	(3)
Western Samoa	0	(3)	(3)	0	(6)	(6)
Brunei	(10)	(1)	(10)	(5)	(1)	(6)
Indonesia	(7)	(3)	(10)	(5)	(4)	(9)
Thailand	(12)	(3)	(16)	(29)	1	(27)
Philippines	(4)	(5)	(9)	(18)	(11)	(29)
Taiwan	34	(70)	(36)	59	(97)	(38)
Macau SAR	(51)	(12)	(63)	(65)	(16)	(82)
Mainland China	(60)	(91)	(151)	(5)	(125)	(130)
Others	0	(2)	(2)	(1)	(2)	(3)
North America	143	120	263	158	186	344
United States	110	118	228	127	188	315
Canada	33	2	36	31	(3)	28
Caribbean	4	0	4	(5)	10	5
Cayman Islands	17	5	22	12	16	28
Bermuda	0	2	2	0	1	1
Panama	0	(1)	(1)	0	0	0
Netherlands Antilles	2	(3)	(2)	1	(2)	(1)
Bahamas	(14)	(7)	(22)	(19)	(7)	(26)
Others	0	4	5	0	2	3
Africa	(13)	(2)	(15)	(8)	(5)	(13)
Liberia	0	0	0	0	(1)	(1)
Mauritius	(13)	(1)	(14)	(8)	(2)	(10)
Others	0	0	0	0	(3)	(3)

Table L: Geographical Breakdown of Net External Claims/(Liabilities) of All Authorized Institutions (cont.)

(HK\$ bn) Region/Economy	2005			2006		
	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	2	(2)	0	0	(3)	(3)
Chile	0	1	1	0	1	1
Brazil	2	(1)	1	0	0	0
Peru	0	0	0	0	(1)	(1)
Venezuela	0	(1)	(1)	0	(1)	(1)
Others	0	(1)	(1)	0	(2)	(2)
Eastern Europe	1	0	1	2	0	1
Western Europe	916	48	965	1,208	16	1,223
United Kingdom	403	(2)	401	543	(17)	526
France	149	5	154	157	1	158
Netherlands	90	15	105	100	13	113
Switzerland	58	(2)	56	111	(4)	107
Belgium	51	(1)	50	56	2	58
Germany	34	4	39	46	6	52
Luxembourg	(7)	13	6	36	6	42
Sweden	17	4	21	31	6	36
Italy	27	12	39	31	1	33
Norway	14	2	15	20	2	21
Republic of Ireland	21	(5)	17	26	(5)	21
Denmark	27	0	27	18	0	18
Austria	14	0	14	16	0	16
Jersey	0	1	1	4	2	6
Iceland	4	0	4	4	0	4
Finland	7	0	7	3	0	4
Spain	5	0	5	4	(1)	3
Portugal	2	0	2	2	0	2
Guernsey	(1)	2	1	(1)	2	2
Greece	0	1	1	0	1	2
Others	0	0	0	1	0	0
Middle East	(6)	4	(1)	9	11	20
United Arab Emirates	0	4	4	4	10	14
Bahrain	(4)	0	(4)	7	(1)	6
Saudi Arabia	1	0	1	2	0	2
Kuwait	0	1	1	0	1	1
Qatar	0	0	0	0	0	1
Iran	(1)	0	(1)	0	0	0
Oman	(1)	0	(1)	(1)	0	(1)
Israel	(2)	0	(2)	(2)	0	(3)
Others	0	0	0	0	0	0
Others^(a)	14	0	14	14	0	14
Overall Total	1,594	10	1,604	2,073	15	2,088

(a) "Others" include economies not listed above and positions in relation to international organisations.

Figures may not add up to total due to rounding.

ABBREVIATIONS USED IN THIS REPORT

ABF	- Asian Bond Fund	HIBOR	- Hong Kong Interbank Offer Rate
ABF2	- Asian Bond Fund 2 (Local currency - denominated Asian Bond Fund)	HKAS	- Hong Kong Accounting Standards
ABIF	- Asian Bond Index Fund	HKICL	- Hong Kong Interbank Clearing Limited
AI	- Authorized institution	HKMA	- Hong Kong Monetary Authority
AML	- Anti-money-laundering	HKMC	- Hong Kong Mortgage Corporation Limited
APEC	- Asia-Pacific Economic Co-operation	HKSAR	- Hong Kong Special Administrative Region
ASEAN	- the Association of Southeast Asian Nations	IMF	- International Monetary Fund
ATM	- Automated teller machine	IPO	- Initial public offering
CAMEL	- Capital adequacy, Asset quality, Management, Earnings and Liquidity of banks	IRB	- Internal Ratings-based approach
CAR	- Capital Adequacy Ratio	IT	- Information technology
CBRC	- China Banking Regulatory Commission	LIBOR	- London Interbank Offer Rate
CCPI	- Composite Consumer Price Index	MDB	- Multilateral Development Bank
CCRA	- Commercial credit reference agency	MoU	- Memorandum of Understanding
CEPA	- Closer Economic Partnership Arrangement	N.A.	- Not applicable
CFT	- Counter-terrorist-financing	NAB	- New Arrangements to Borrow
CHATS	- Clearing House Automated Transfer System	NCD	- Negotiable certificate of deposit
CI	- Certificate of Indebtedness	NDI	- Negotiable debt instrument
CLS	- Continuous Linked Settlement	OCL	- Octopus Cards Limited
CMU	- Central Moneymarkets Unit	OECD	- Organisation for Economic Co-operation and Development
CRA	- Credit rating agency	OGC	- The Office of the General Counsel
CSSO	- Clearing and Settlement Systems Ordinance	PAIF	- Pan-Asian Bond Index Fund
DCA	- Debt collection agency	PvP	- Payment-versus-Payment
DvP	- Delivery-versus-Payment	QDII	- Qualified Domestic Institutional Investors
ECAI	- External credit assessment institutions	RI	- Registered Institutions
EFAC	- Exchange Fund Advisory Committee	RMB	- Renminbi
EFBN	- Exchange Fund Bills and Notes	RMD	- Reserves Management Department
EMEAP	- Executives' Meeting of East Asia-Pacific Central Banks	RSS	- Renminbi Settlement System
EPS	- Easy Pay System	RTGS	- Real Time Gross Settlement
FATF	- Financial Action Task Force	SAFE	- State Administration of Foreign Exchange
F/CY	- Foreign currency	SARS	- Severe Acute Respiratory Syndrome
FVO	- Fair value option	SFC	- Securities and Futures Commission
GDP	- Gross Domestic Product (in real terms unless otherwise stated)	SPE	- Special Purpose Entities
GSC	- Governance Sub-Committee	SPM	- Supervisory Policy Manual
		TMA	- Treasury Markets Association
		VaR	- Value-at-Risk

REFERENCE RESOURCES

The *HKMA Annual Report* is published in April or May each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

HKMA Quarterly Bulletin

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (on-line 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)

HKMA Background Brief No. 2 - Banking Supervision in Hong Kong

HKMA Background Brief No. 3 - Mandate and Governance of the Hong Kong Monetary Authority

HKMA Background Brief No. 4 - Financial Infrastructure 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.

 > [HKMA Information Centre](#)

Most HKMA publications are also available for downloading free of charge from the HKMA website (www.hkma.gov.hk). A mail order form for the purchase of print publications can be found on the website.

 > [Publications](#)

The main texts of the regular briefings by the HKMA to the Legislative Council Panel on Financial Affairs are available online.

 > [Legislative Council Issues](#)

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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HK\$100

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AN INTRODUCTION TO THE
HONG KONG MONETARY AUTHORITY
2007 EDITION

Incorporating the Summary Version of the HKMA Annual Report 2006



HONG KONG MONETARY AUTHORITY
香港金融管理局

THE HONG KONG MONETARY AUTHORITY

Established in April 1993, 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, through sound management of the Exchange Fund, monetary policy operations and other means deemed necessary
- to promote the safety and stability of the banking system through the regulation of banking business and the business of taking deposits, and the supervision of authorized institutions
- to enhance the efficiency, integrity and development of the financial system, particularly payment and settlement arrangements.

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The first part of this booklet introduces the work and policies of the HKMA. The second part contains a summary of the HKMA's Annual Report for 2006. The full Annual Report is available on the HKMA website both in interactive form and on PDF files. Hard copies may also be purchased from the HKMA: see Reference Resources on page 56 for details.

This booklet makes reference to documents and other materials available on the HKMA website www.hkma.gov.hk. These references appear as , followed by navigation guidance from the HKMA homepage.

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

About the HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.

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

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 cooperation 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.

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. The HKMA's weekly *Viewpoint* column, carried on the HKMA website and in several Hong Kong newspapers, informs the public about aspects of the HKMA's work. Further information on the HKMA's media work, publications and public education programmes is contained in the Chapter on Professional and Corporate Services.

 > Viewpoint

 > HKMA Information Centre

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 monthly reports on Currency Board operations. The supervisory policies and guidelines on banking have been published on the website since 1996.

 > [Press Releases > Exchange Fund](#)

 > [Supervisory Policy Manual](#)

 > [Guidelines and Circulars](#)

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. At one of these briefings, usually in May, the HKMA's Annual Report is presented. 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.

 > [Legislative Council Issues](#)

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 includes 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.

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 2006 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.

Membership (1 April 2007)

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP

The Financial Secretary

Members

Mr Joseph YAM, GBS, JP

The Monetary Authority

Dr The Hon. Marvin CHEUNG Kin-tung,

DBA Hon., SBS, JP

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

The Hon. Victor LO Chung-wing, GBS, JP

Chairman and Chief Executive

Gold Peak Industries (Holdings) Limited

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer

Johnson Electric Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, JP

Vice-Chairman and Managing Director

Sun Hung Kai Properties Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Dr Patrick FUNG Yuk-bun

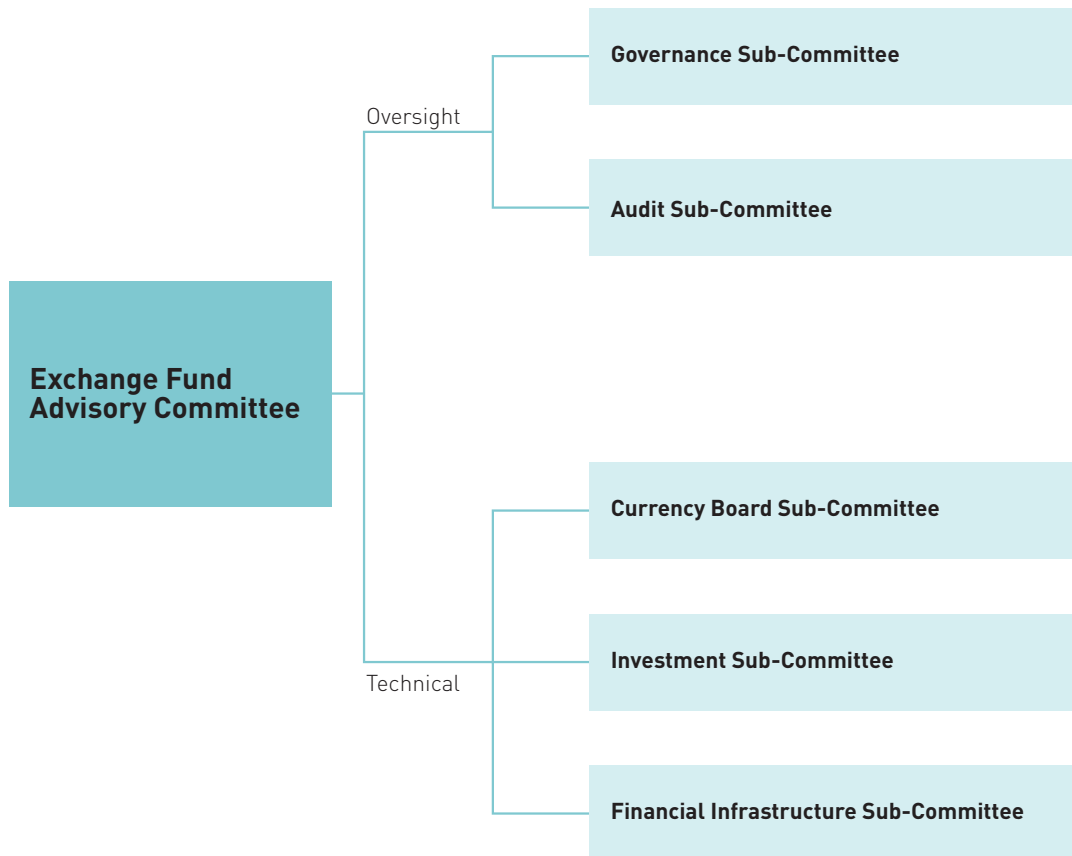
Chairman and Chief Executive

Wing Hang Bank Limited

Secretary

Mr Trevor KEEN

EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



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 seven times in 2006 to consider a range of subjects including disclosure of information on the HKMA's expenditure budget, the HKMA's performance assessment, the annual pay review, the HKMA Annual Report, business continuity planning, strategic planning matters and post-termination employment arrangements. The Sub-Committee also received regular reports on the work of the HKMA.

Membership (1 April 2007)

Chairman

Dr The Hon. Marvin CHEUNG Kin-tung,

DBA Hon., SBS, JP

Members

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

(Mr Cheng was chairman at meetings in the absence of Dr Cheung)

The Hon. Victor LO Chung-wing, GBS, JP

Chairman and Chief Executive

Gold Peak Industries (Holdings) Limited

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer

Johnson Electric Holdings Limited

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, JP

Vice-Chairman and Managing Director

Sun Hung Kai Properties Limited

Secretary

Mr Trevor KEEN

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.

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. The Sub-Committee met twice in 2006.

Membership (1 April 2007)

Chairman

Dr The Hon. Marvin CHEUNG Kin-tung,

DBA Hon., SBS, JP

Members

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

Mr Simon IP Sik-on, JP

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

The Hon. Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

(Mr Fan was chairman at meetings in the absence of Dr Cheung)

Secretary

Mr Trevor KEEN

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.

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 monthly reports on Currency Board operations submitted to the Sub-Committee are published. In 2006 the Sub-Committee met four times. Topics discussed included a review of the Hong Kong dollar effective exchange rate, estimating the demand for narrow money and broad money, Hong Kong's business cycle synchronisation with Mainland China and the US, and the implications of relaxing the three-year tenor issuance restriction on multilateral development banks for monetary stability and market development potential.

 > [Press Releases](#) > [Monetary Policy](#)

Membership (1 April 2007)

Chairman

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

Mr William RYBACK, JP
Deputy Chief Executive
Hong Kong Monetary Authority

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

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr John GREENWOOD
Group Chief Economist
INVESCO Asset Management Limited

Professor TSANG Shu-ki
Department of Economics
Hong Kong Baptist University

Professor K C CHAN, JP
Dean of Business and Management
Hong Kong University of Science and Technology

Mr Peter SULLIVAN
Chairman
The Hong Kong Association of Banks

Secretary

Mr Trevor KEEN

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.

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 2006.

Membership (1 April 2007)

Chairman

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
USI Holdings Limited

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

Professor K C CHAN, JP
Dean of Business and Management
Hong Kong University of Science and Technology

The Hon. Henry FAN Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited

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

Mr Vincent CHENG Hoi-chuen, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited

Secretary

Mr Trevor KEEN

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.

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 2006 the Sub-Committee met three times.

Membership (1 April 2007)

Chairman

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

Mr Y K CHOI, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Christopher CHENG Wai-chee, GBS, JP
Chairman
USI Holdings Limited

Dr Patrick WANG Shui-chung, JP
Chairman and Chief Executive Officer
Johnson Electric Holdings Limited

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

Mr Vincent CHENG Hoi-chuen, GBS, JP
Chairman
The Hongkong and Shanghai Banking Corporation Limited

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

Secretary

Mr Trevor KEEN

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.

The 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.

Membership (1 April 2007)

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP
The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP
The Monetary Authority

Members

The Hon. Frederick MA Si-hang, JP
Secretary for Financial Services and the Treasury

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

Mr Peter WONG Tung-shun, JP
Executive Director
The Hongkong and Shanghai Banking Corporation Limited
Representing The Hongkong and Shanghai Banking Corporation Limited

Mr Peter SULLIVAN

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

Mrs Doreen CHAN HUI Dor-lam

President and Chief Executive Officer
CITIC Ka Wah Bank Limited

Mrs Mignonne CHENG

Head of North and East Asia
BNP Paribas

Dr The Hon. David LI Kwok-po

, LLD, GBS, JP

Chairman and Chief Executive
The Bank of East Asia Limited

Ms Maria XUEREB

Financial Services Partner
Deloitte Touche Tohmatsu

Mr Ignatius CHAN Tze-ching

, JP

Citigroup Country Officer, Hong Kong & Head of Greater China
Corporate and Investment Banking
Citibank, N.A.

Mr Hideo HIYAMA

Director, General Manager & Regional Chief Executive
Sumitomo Mitsui Banking Corporation
Hong Kong Branch

Mr James C K WONG

Chief Executive Officer
Dah Sing Life Assurance Company Limited

Mr Stanley Y F WONG

Director & Deputy General Manager
Industrial and Commercial Bank of China (Asia) Limited

Secretary

Ms Jasmin FUNG

The 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.

Membership (1 April 2007)

Chairman

The Hon. Henry TANG Ying-yen, GBS, JP

The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

The Hon. Frederick MA Si-hang, JP

Secretary for Financial Services and the Treasury

Mr Martin WHEATLEY

Chief Executive Officer

Securities and Futures Commission

Representing the Securities and Futures Commission

Mr Geoffrey J MANSFIELD

Chairman

The DTC Association (The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies)

Representing The DTC Association

Ms Connie LAU Yin-hing

Chief Executive

Consumer Council

Representing the Consumer Council

Ms Kitty IU Pui-pui

Managing Director

Scotiabank (Hong Kong) Limited

Mr Mervyn JACOB

Partner

Assurance, Financial Services Practice

PricewaterhouseCoopers

Mr Frank J WANG

Executive Director and Deputy Chief Executive

Wing Hang Finance Company Limited

Mr Erik Helge WEINER

Chairman & Chief Executive

JP Morgan Securities (Asia Pacific) Limited

The Hon. CHAN Kam-lam, SBS, JP

Member

Legislative Council

Mr Michael CHANG Ming-yuen

Director

Fubon Credit (Hong Kong) Limited

Mr CHOI Jong Ha

Managing Director and Chief Representative

KDB Asia Limited

Mr Yasuhiro MATSUMURA

Chairman

Mitsubishi UFJ Securities (HK) Capital, Limited

Secretary

Ms Jasmin FUNG

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.

Brief biographies of 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.

 > The HKMA > Advisory Committees

 > The HKMA > The Chief Executive's Committee

Maintaining Monetary Stability

THE LINKED EXCHANGE RATE SYSTEM

The monetary policy objective of Hong Kong is currency stability. This is defined as a stable external exchange value of the Hong Kong dollar in terms of its exchange rate against the US dollar at around HK\$7.80 to one US dollar. The monetary policy objective is achieved through the Linked Exchange Rate system, which has been implemented since 17 October 1983. The Linked Exchange Rate system plays an important part in supporting Hong Kong's role as a trading, service and financial centre.

THE CURRENCY BOARD SYSTEM

Exchange rate stability in Hong Kong is achieved through a Currency Board system. The Monetary Base is fully backed by foreign currency reserves at the fixed exchange rate of HK\$7.80 to US\$1. Any change in the Monetary Base must be fully matched by corresponding changes in foreign currency reserves.

Hong Kong's Monetary Base consists of four components:

- Certificates of Indebtedness, which back the banknotes issued by the three note-issuing banks

- government-issued currency notes and coins in circulation
- the sum of the balances of the clearing accounts maintained by banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, which are issued by the HKMA on behalf of the Government.

Under the Currency Board system, the stability of the Hong Kong dollar exchange rate is maintained through an interest rate adjustment mechanism.

In recent years the Currency Board system has been strengthened to make it more transparent and resilient to external shocks. In particular, the HKMA has provided a clear undertaking to all banks to convert their Hong Kong dollar clearing balances into US dollars at the Convertibility Rate of HK\$7.85 to US\$1, and in the other direction to convert their US dollars into Hong Kong dollars at the Convertibility Rate of HK\$7.75 to US\$1.

 > Monetary Stability > Currency Board System

The Currency Board mechanism



Promoting Banking Safety

The principal function of the HKMA as banking supervisor is to promote the general stability and effective working of the banking system in Hong Kong. The HKMA seeks to ensure that banks and deposit-taking companies in Hong Kong operate in an effective, responsible, honest and business-like manner to provide a measure of protection to depositors. The HKMA derives its powers as banking supervisor from the Banking Ordinance.

THE THREE TIERS OF BANKING IN HONG KONG

Hong Kong's banks are divided into three tiers of authorized institutions (AIs). The main distinctions lie in the deposit business each tier of institution is allowed to conduct under the Banking Ordinance.

The HKMA is the licensing authority for AIs under the Banking Ordinance. The HKMA's supervisory approach is based on a policy of continuous supervision. This involves ongoing monitoring of AIs through the use of a variety of techniques, including on-site examinations, off-site reviews, prudential meetings, meetings with boards of directors or board-level committees, co-operation with external auditors, and sharing of information with other supervisors. The aim is to try to ensure that any problems affecting AIs are detected and addressed at an early stage.

The HKMA uses a risk-based supervisory approach to ensure that AIs have the necessary risk management systems to identify, measure, monitor and control the risks inherent in their operations. This enables the HKMA to be more proactive in pre-empting any serious threat to the stability of the banking system.

 > Banking Stability

Three tiers of authorized institutions	Deposit business permitted
Licensed banks	Current accounts, savings deposits and time deposits of any size and maturity
Restricted licence banks	- Time deposits of HK\$500,000 or more for any maturity - Savings and current accounts are not permitted
Deposit-taking companies	- Time deposits of HK\$100,000 or more for at least three months - Savings and current accounts are not permitted

Managing The Exchange Fund

THE EXCHANGE FUND

The Exchange Fund was established in 1935 with the primary objective to safeguard the exchange value of the Hong Kong dollar. Holding Hong Kong's foreign currency reserves, the Exchange Fund is the cornerstone of maintaining the stability and integrity of monetary and financial systems in Hong Kong, and provides the backing to maintain the Linked Exchange Rate system.

The Exchange Fund Ordinance stipulates the establishment, control and management of the Exchange Fund. According to the Ordinance, the Exchange Fund is under the control of the Financial Secretary, who delegates the management responsibilities of the Exchange Fund to the Monetary Authority, based on the powers and duties conferred on him under the Ordinance. In consultation with the Exchange Fund Advisory Committee, the Financial Secretary determines the investment policies and strategies for the Exchange Fund with its day-to-day management responsibilities rested with the Monetary Authority.

INVESTMENT OBJECTIVES

The investment objectives of the Exchange Fund are

- (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 sufficient liquidity for the purpose of maintaining monetary and financial stability; and
- (d) subject to (a) - (c) above, to achieve an investment return that will preserve the long-term purchasing power of the Fund.

INVESTMENT PROCESS

The Exchange Fund is divided into two main portfolios - the Backing Portfolio and the Investment Portfolio. The Backing Portfolio is used to hold US dollar denominated assets for the purpose of providing full backing for the Monetary Base of Hong Kong. The Investment Portfolio is used to hold different asset classes aiming at preserving the value and long-term purchasing power of the Fund. Under the Linked Exchange Rate system, all Exchange Fund assets in the Backing Portfolio and the Investment Portfolio can be used to support the Hong Kong dollar exchange rate.

The long-term asset allocation strategy of the Fund is governed by the investment benchmark, which is set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee. The benchmark represents the optimal mix of assets designed to meet the investment objectives.

USE OF EXTERNAL MANAGERS

The Exchange Fund employs global external managers to manage about one third of its total assets, including all of its equity portfolios and other specialised assets. The purpose of appointing external managers is to add value to the investment process by tapping the best of the investment expertise available in the market, to capture a diverse mix of investment styles within the global investment field, and, if possible, to help transfer market knowledge and information to in-house professionals.

Developing Financial Infrastructure

POLICY OBJECTIVE

The HKMA is committed to promoting a safe, efficient and reliable financial market infrastructure to help maintain Hong Kong's status as an international financial centre. The HKMA oversees the important clearing and settlement systems in Hong Kong under the Clearing and Settlement Systems Ordinance. It fosters the local and regional debt markets and develops settlement systems for cross-border transfers of funds and securities. The long-term aim is for Hong Kong to be a leading centre of financial intermediation, where all types of financial transactions, initiated from whatever location or time zone and in whatever currency, whether at the wholesale or retail level, can be executed and settled in real time.

PAYMENT SYSTEMS IN HONG KONG

Since 1996, interbank funds transfers have been settled in real time through the Hong Kong dollar Real Time Gross Settlement (RTGS) system - the Clearing House Automated

Transfer System (CHATS). This means that payment is processed continuously and finality of settlement is instantaneous. The advantages are speed, efficiency and safety.

Building on the technology of the Hong Kong dollar RTGS system, the HKMA introduced a US dollar RTGS system in 2000, a euro RTGS system in 2003 and a renminbi RTGS system in 2007.

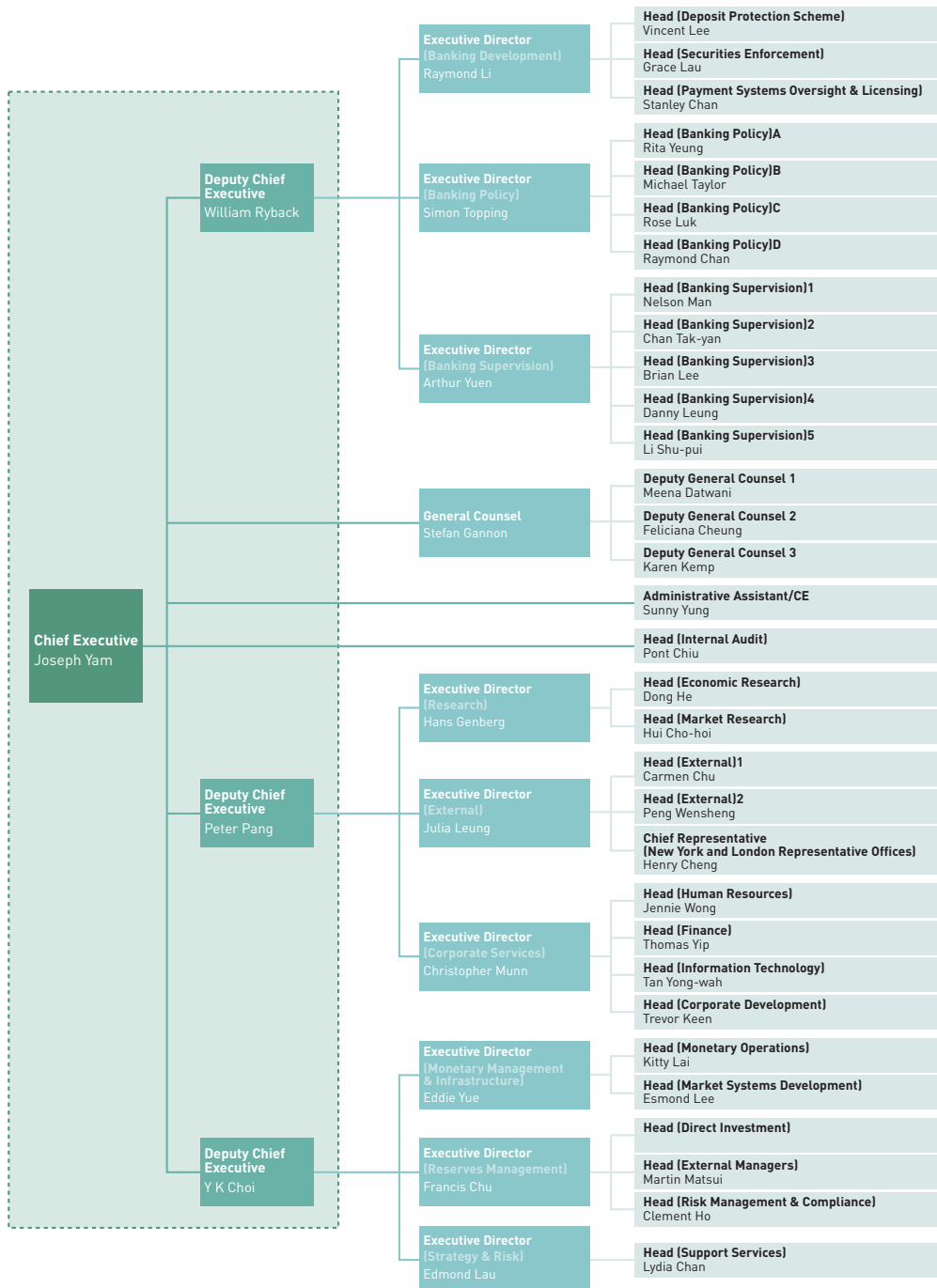
CENTRAL MONEYMARKETS UNIT

The Central Moneymarkets Unit (CMU), operated by the HKMA, provides an efficient clearing, settlement and depository service for both Hong Kong dollar and other international debt securities. Since its establishment in 1990 the CMU has developed links with overseas central securities depositories. Through these links, local investors can hold and settle securities lodged with overseas depositories more efficiently, and overseas investors can do the same in Hong Kong.

 > Financial Infrastructure

HKMA ORGANISATION CHART

1 April 2007



REVIEW OF 2006

Summary Version of the
HKMA Annual Report 2006



Chief Executive's Statement



The HKMA had another busy and, I believe, successful and productive year in 2006: the Hong Kong dollar exchange rate remained stable despite record fund flows, the banking sector remained strong, the Exchange Fund earned a respectable investment return, and some real progress was made in mapping out a strategy for Hong Kong's world-class financial infrastructure to contribute to the further development of China's economy.

Economic trends

Hong Kong's economy grew by 6.8% in 2006, lower than the 7.5% in 2005 but still above trend and very respectable. Monetary conditions eased, reflecting high levels of liquidity in the banking sector, but were broadly neutral. Unemployment declined to its lowest level in six years, while inflation picked up slightly but not yet to levels that would cause concern. Growth in the economy was mainly driven by domestic demand, particularly consumer spending and investment in business equipment. At the same time, exports of goods and services were robust with increases in trade with the Mainland and solid demand from our other major trading partners.

Asset markets performed well: the residential property market was stable after a strong rise in 2005, with little sign of overheating; and the stock market staged a strong rally in the second half of the year, with the Hang Seng Index increasing by 34% to reach a record high of 20,001 on 28 December. This rise was supported by Hong Kong's strong economic performance, the pause in monetary tightening in the US, and large inflows of funds related to initial public offerings, mostly of Mainland stocks.

The Exchange Fund

That the Exchange Fund enjoyed a good year in 2006 is already old news: the Fund earned an investment return of \$103.8 billion, a rate of return of 9.5%. This exceeded the rate of return of the benchmark portfolio approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee (EFAC) by more than 0.6%. The share of the investment income going to the fiscal reserves placed with the Exchange Fund was \$28.9 billion.

Good results are always welcome, of course. We are glad to have contributed to a healthy investment return for the people of Hong Kong. But we are also very conscious that this is not the primary purpose of the Exchange Fund. The purposes and investment objectives of the Fund are set out in detail in the Reserves Management chapter: in essence, the Fund is there to back the Hong Kong dollar, and to do that it has to be held primarily in liquid US dollar assets and its investment objectives emphasise capital preservation and liquidity. I have said this many times but perhaps it bears repeating once more: the Exchange Fund has to be invested, but it is not an investment fund and investment is not its primary purpose.

The implication of this is that we cannot and should not expect high returns from the Fund every year. Like the savings that many of us hold, the Exchange Fund can be thought of as rainy-day money: we want to get a good return on it but we must always remember that we might need it for some emergency and therefore be prudent in how we invest it. Looking ahead to 2007, I believe that caution is called for. While I believe we did well in outperforming the benchmark, the overall results of 2006 were due in large part to equities and bond markets rising together towards the end of the year and a number of equities markets in particular reaching historic highs. We all understand that markets are cyclical and when you reach high levels, the outlook for the future is uncertain at best.

Hong Kong dollar stability

The Hong Kong dollar exchange rate is always a focus for the HKMA given our mandate to preserve currency stability. I am pleased to say that the Hong Kong dollar remained stable within the Convertibility Zone throughout the year, despite some very large fund flows related to initial public offerings and speculation about the effect on the Hong Kong dollar of the renminbi's appreciation. Looking back at the 2005 Annual Report, I note that last year I talked about record fund flows from initial public offerings: those records were greatly exceeded in 2006 with \$333 billion being raised in the local stock market, including \$125 billion for a single issue.

Earlier in the year, many in the financial markets seemed to believe that the Hong Kong dollar would follow the renminbi in appreciating against the US dollar and other major currencies, and there was speculation that we would abandon the Linked Exchange Rate system. Quite why anyone should think that we would give up an anchor that has served us well and helped to maintain stability through some very difficult and potentially destabilising times over the last 23 years is something of a mystery. But the HKMA's job is to ensure stability and if people found my repeated statements that there was no plan or intention to abandon the link to the US dollar a little boring, then I do not mind very much. Dullness can be a virtue in our business. We spent a lot of time explaining to the markets and the wider community that the strengthening of the renminbi to parity with the Hong Kong dollar and beyond would not affect the Hong Kong dollar exchange rate, although we of course could not rule out short-term psychological effects on the financial markets. We also explained that, given the correlation of the business cycles in Hong Kong and the US and the fact that an overwhelming amount of our external trade is denominated in US dollars, the link with the US dollar remained appropriate for the Hong Kong economy and the best way to ensure stability. In the event, the markets largely shared this view and the renminbi passed through various psychologically significant levels without causing any ripples to the stability of the Hong Kong dollar: the Currency Board system functioned normally and we were not required to take any action to stabilise the exchange rate.

The banking sector

Hong Kong continues to have a robust banking system despite a very competitive operating environment. The profitability of the banks improved because of higher net interest margins and loan growth, leading to higher net interest income. Income from fees and commissions also increased, more than offsetting lower treasury income and an increase in provisions. Overall asset quality remained good: although the credit card portfolio weakened slightly, the decline in quality was from a level many other markets would regard with envy and the resulting increase in provisions was small by historical standards. The local banking sector is well placed to continue to support economic growth.

But that does not mean the HKMA should not remain active and vigilant in its role of promoting the safety and stability of the banking sector. In addition to the continuing day-to-day regulation work, largely unseen by the public but of great importance to ensuring a stable banking industry, the HKMA has been working hard to make improvements in this area. In 2006 my colleagues in the banking departments continued to develop risk-based supervision and completed the enormous volume of work related to the implementation of the Basel II arrangements, which formally began on 1 January this year when the *Banking (Capital) Rules* and the *Banking (Disclosure) Rules* came into force. Hong Kong is among the first jurisdictions in the world to implement Basel II and this makes us very much a leader in the region. A great deal more detailed and painstaking work lies ahead of us.

The Deposit Protection Scheme commenced operations on 25 September and the evidence so far suggests that the Scheme, which provides a measure of protection to depositors, is already helping to increase confidence in the banking sector. Another area where we increased our efforts in 2006 is in monitoring controls on money laundering and terrorist financing: sad to say, these problems are going to be with us for the foreseeable future and we have had to devote more resources to them. It would be a brave person who would say that we can prevent such dealings, but we are committed to doing everything we can to make it harder for criminals to abuse our financial systems.

Hong Kong as an international financial centre

The year saw a number of highlights in the development of Hong Kong as an international financial centre. The international credit rating agencies upgraded Hong Kong's sovereign ratings to AA, the highest they have ever been. The HKMA, working with the Government, played an important role in helping the agencies achieve a better understanding of Hong Kong's economic and financial strengths. We also worked hard during the year with the Mainland authorities on the expansion of renminbi business in Hong Kong, leading in January this year to the State Council's agreement to the issuance of renminbi bonds in Hong Kong by Mainland institutions, the first time that such instruments will be issued outside the Mainland.

The HKMA also developed a blueprint for the financial development of Hong Kong that was adopted as part of the report by the Focus Group on Financial Services set up by the Chief Executive's Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong". The blueprint aims to set out how Hong Kong's already developed financial systems can contribute to the development of the nation's economy and give China the kind of international financial centre the world's fourth-largest and fastest-growing economy ought to have. This is a long-term goal and I have no doubt the strategy will need to be revised from time to time and progress will sometimes seem slower than we would like. But it is surely something worth achieving and we should all commit ourselves to it.

A safe and efficient financial infrastructure

An aspect of Hong Kong's financial system that receives very little public attention is its world-class financial infrastructure. Efficient and safe payment and settlement systems are often taken for granted and few people not directly involved know much about them: people just assume that when they commit funds to a transaction, the money will arrive safely and on time at the other end. This is not the place for a detailed explanation of what are very complex systems but I will just note that on a single day, 27 October 2006, \$1.37 trillion, roughly equivalent to Hong Kong's annual gross domestic product, passed through the clearing-house system without any problems. There were also no settlement failures during the year. This does not just happen: a lot of people work very hard to ensure that the systems operate efficiently and the HKMA puts a great deal of effort not just into maintaining the systems but also into making sure that they are developed and improved to keep ahead of the demands placed upon them.

Governance and transparency

I am always conscious that the HKMA bears a great responsibility in the stewardship of public resources. We manage a very large amount of public money and perform functions that directly affect Hong Kong's financial well-being. The HKMA maintains a degree of separation from the rest of the Hong Kong Special Administrative Region Government, although we are an integral part of it. We have a certain level of autonomy in our day-to-day operations, in our funding arrangements, and in the employment of staff on terms different from those of the civil service. These arrangements are consistent with the generally accepted principle that central banking institutions should have resource independence to allow them to carry out their functions without political interference. But this does not mean that the HKMA should not be accountable for how it performs those functions and we are in fact accountable to the Financial Secretary through EFAC and to the community, both directly and through the Legislative Council. EFAC and its Sub-Committees, especially the Governance Sub-Committee, continue to keep a close eye on our operations and to offer us much valuable advice and guidance. We have adopted a policy of transparency that compares favourably with those of the major central banks around the world. I brief the Legislative Council's Panel on Financial Affairs three times a year on the work of the HKMA and matters affecting the economy. This Annual Report is also an important part of our transparency policy and this year we have included a number of improvements and additional items of information that I hope will help the community better understand what we do and how we do it.

Finally, I would like to thank my colleagues for their continued hard work and dedication during the year, and we are all grateful to the Members of EFAC who give up so much of their time and energy to provide us with their guidance.

A stylized, handwritten signature in black ink, consisting of a large, flowing 'J' followed by a series of loops and a long horizontal stroke extending to the right.

Joseph Yam
Chief Executive

Economic and Banking Environment in 2006

ECONOMIC PERFORMANCE

The Hong Kong economy grew above trend for the third consecutive year in 2006. Real GDP increased by 6.8% after expanding by 7.5% in 2005 and 8.6% in 2004. Strong domestic demand and expansion in exports supported growth. Reflecting rising aggregate demand and higher housing rents, consumer price inflation picked up gradually in 2006. Labour market conditions continued to improve, with the unemployment rate declining to 4.4% in the fourth quarter of 2006.

PROSPECTS FOR 2007

The outlook for 2007 remains favourable. The Hong Kong economy will continue to benefit from strong economic performance in Mainland China. The market expects real GDP growth in 2007 to moderate, reflecting a slowdown in global demand. Consumer price inflation is expected to pick up modestly in 2007, partly reflecting rising domestic demand and higher import prices. A number of uncertainties, however, surround the benign outlook. They include a sharper-than-expected slowdown in the US economy, further tightening of monetary policy in industrialised economies, and significant reversal of international capital flows. Other medium-term risks include large global imbalances, rising trade protectionism and overheating on the Mainland.

PERFORMANCE OF THE BANKING SECTOR

The banking sector achieved another year of solid results in 2006 despite the operating environment remaining intensely competitive. Retail banks' pre-tax operating profits in 2006 increased by 10.1% from the previous year, mainly supported by improved net interest margins and loan growth.

PROSPECTS FOR THE BANKING SECTOR IN 2007

Banks' capital and liquidity positions prepare them well to continue to support economic growth. Attention needs to be paid to liquidity and interest rate risks, however, because the liquidity position seen in 2006 may not persist in 2007. Attention also needs to be paid to pricing risks properly and maintaining credit underwriting standards as competition continues to remain intense. Banks are likely to continue to look for business opportunities in Mainland China, placing a particularly high premium on their ability to identify, manage and control the associated risks.

CURRENCY

At the end of 2006, the total value of notes and coins in circulation reached more than \$164 billion, an increase of more than 5.2% from 2005. To help strengthen awareness of counterfeiting, 37 education seminars were organised during the year for about 2,800 bank cashiers and retailers. These education efforts will continue in 2007.



> Consumer Information > Notes and Coins

HONG KONG'S ECONOMY

	2005	2006
Economic growth and inflation		
Real growth in Gross Domestic Product (%)	7.5	6.8 ^(a)
of which:		
Real growth in private consumption expenditure (%)	3.3	5.1 ^(a)
Real growth in gross domestic fixed capital formation (%)	4.6	7.9 ^(a)
Real growth in exports (%)	11.2	9.9 ^(a)
Real growth in imports (%)	8.5	9.7 ^(a)
Composite Consumer Price Index (annual change, %)	1.0	2.0
Labour market		
Employment (annual change, %)	2.0	2.1
Unemployment rate (annual average, %)	5.6	4.8
Money supply (annual change, %)		
Hong Kong dollar money supply (M1)	-15.6	11.4
Hong Kong dollar money supply (M2) ^(b)	5.5	19.2
Hong Kong dollar money supply (M3) ^(b)	5.7	19.2
Interest rates (end of year, %)		
Three-month interbank rate	4.16	3.84
Savings deposit rate	2.32	2.26
Best lending rate	7.75	7.75
Composite rate	2.88	2.86
Exchange rates (end of year)		
Hong Kong dollar/US dollar	7.753	7.775
Trade-weighted effective exchange rate index (Jan 2000=100)	98.4	94.3
Hang Seng Index (end of year)		
	14,876	19,965

(a) The estimates are preliminary.

(b) Adjusted to include foreign currency swap deposits.

PERFORMANCE RATIOS OF HONG KONG'S BANKING SECTOR

	2005 %	2006 %	2005 %	2006 %
	All AIs		Retail banks*	
Profitability^[a]				
Growth of pre-tax operating profit	N.A.	N.A.	8.28	10.14
Return on assets (operating profit before tax)	1.07	1.13	1.55	1.53
Return on assets (post-tax profit)	0.97	1.00	1.40	1.35
Net interest margin	1.18	1.29	1.68	1.80
Bad debt charge to average total assets	0.01	0.03	-0.01	0.01
Business profile^[a]				
Growth in loans to customers	7.2	6.7	9.8	4.0
Growth in customer deposits (all currencies)	5.2	17.2	3.1	15.6
Hong Kong dollar loan to deposit ^[b] ratio	84.3	74.7	78.8	69.1
Asset quality^[c]				
Classified loans ^[d] as percentage of total loans	1.34	1.05	1.37	1.11
All locally incorporated AIs				
Capital Adequacy Ratio (consolidated)			14.8	15.0

Notes:

(a) Figures are related to Hong Kong office(s) only.

(b) Includes swap deposits.

(c) Figures are related to Hong Kong office(s) and, in the case of local AIs, include overseas branches.

(d) Denotes loans graded as "substandard", "doubtful" or "loss".

* This comprises all the locally incorporated banks plus a number of the large foreign banks which are not locally incorporated but whose operations are similar to those of the locally incorporated banks, in that they operate a branch network and are active in retail banking.

Monetary Conditions in 2006

REVIEW OF 2006

Hong Kong's foreign exchange and money markets were stable in 2006. The Hong Kong dollar spot exchange rate fluctuated between the Linked Rate of 7.8 to one US dollar and the strong-side Convertibility Undertaking of 7.75 during the year.

Movements in Hong Kong dollar interbank interest rates largely followed those in their US dollar counterparts. The Hong Kong Interbank Offered Rates rose in the first half of the year, tracking increases in the US federal funds target rate. Since the US Fed stopped raising the target rate in August, Hong Kong dollar interest rates have been steady, moving between four and five per cent.

Amid ample liquidity, Hong Kong dollar interbank interest rates stayed below their US dollar counterparts during the year. But the negative interest rate spreads in 2006 were not large compared to historical standards. From a macroeconomic perspective, monetary conditions in 2006 were broadly neutral.

The Convertibility Undertakings were not triggered in 2006, and the HKMA did not conduct any foreign exchange operations. The Aggregate Balance remained stable at around \$1.3 billion, and interest rate volatility continued to remain low.

ACTIVITIES AT THE HKMA

The Currency Board Sub-Committee of the Exchange Fund Advisory Committee continued to oversee the operation of the Currency Board system and examine issues affecting monetary and financial stability in Hong Kong.

The Hong Kong Institute for Monetary Research conducts research in monetary policy and banking and finance issues that are of strategic importance to Hong Kong and the region, and promotes central bank co-operation in research.



› Press Releases › Monetary Policy

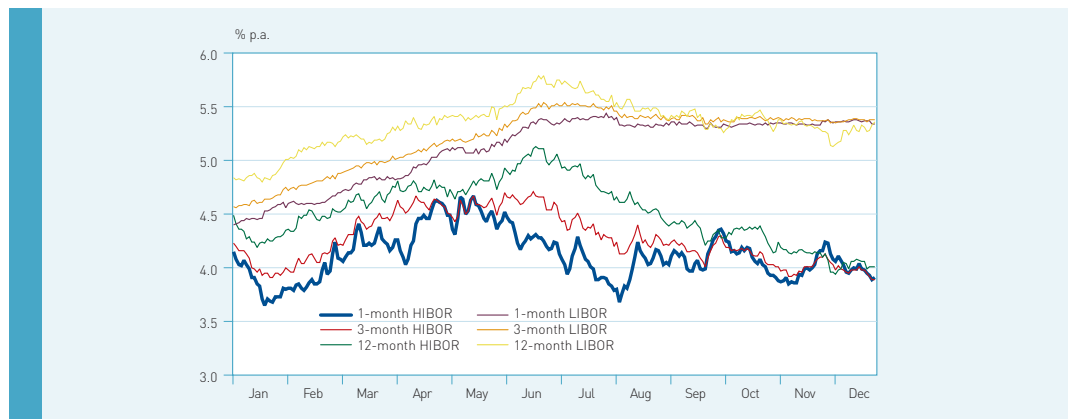


› Research Memorandums

Chart 1. Market exchange rate, January-December 2006



Chart 2. HIBORs and LIBORs, January-December 2006



Banking Policy and Supervisory Issues in 2006

RISK-BASED SUPERVISION

In 2006 the HKMA further developed its risk-based supervisory approach. More resources were allocated to thematic examinations of selected authorized institutions. Benchmarking the risk management and internal control of authorized institutions were the supervisory focus during the year. The HKMA also helped the banks to identify emerging risks, and issued guidance on sound industry practices in these areas.

Table 1. Operational Supervision

	2005	2006
1. On-site examinations	228	247
<i>Regular examinations</i>		
– risk-based	92	86
– overseas	11	10
<i>Specialised examinations</i>		
– treasury and derivatives activities	8	9
– securities (tier-2)	5	7
– e-banking activities and technology risk management	17	5
– AML/CFT controls (tier-2)	–	4
– business continuity plan	17	15[#]
<i>Thematic examinations</i>		
– renminbi banking business	18	25
– implementation of the standardized (credit risk) approach and the IRB approach under Basel II	–	17
– AML/CFT controls over correspondent banking and private banking	–	22
– controls for protecting customer data	–	15
– retail wealth management	14	22
– investment advisory activities	–	10
– trade financing	22	–
– residential mortgage	24	–
2. Off-site reviews and prudential interviews	187	185
3. Tripartite meetings	71	51
4. Meetings with boards of directors or board-level committees of AIs	18	21
5. Approval of applications to become controllers, directors, chief executives, alternate chief executives of AIs	332	278
6. Reports commissioned under Section 59(2) of the Banking Ordinance	4	1
7. Cases considered by the Banking Supervision Review Committee	7	15

[#] In 2006, the examinations focused on assessing AIs' preparedness for a possible pandemic.

DEPOSIT PROTECTION SCHEME

The Scheme was launched on 25 September 2006. Eligible depositors are now entitled to compensation of up to \$100,000 in the event of a bank failure. The Deposit Protection Board, with the assistance of the HKMA, launched an extensive publicity programme about the Scheme.

BASEL II

Following extensive consultation, the Banking (Capital) Rules and Banking (Disclosure) Rules were passed by the Legislative Council in November 2006, enabling Basel II to be implemented in Hong Kong on 1 January 2007.

CONSUMER PROTECTION

One hundred and seventy-two authorized institutions providing personal banking services completed the annual self-assessment of compliance with the *Code of Banking Practice* covering the period from June 2005 to May 2006. More than 87% reported full compliance with the Code. Non-compliances were mainly related to the advance of loans and overdrafts, and the terms and conditions of banking services. The HKMA required authorized institutions to take prompt remedial actions to address any non-compliance.

In 2006 the HKMA received 292 complaints about banking services provided by authorized institutions, compared with 328 in 2005. The decline applies to all types of banking services, including complaints against the use of debt collection agencies by authorized institutions.

 > Banking Stability

 > Consumer Information

Market Infrastructure in 2006

OPERATION OF PAYMENT SYSTEMS

The Hong Kong dollar, US dollar and euro payment systems continued to function efficiently in 2006. The daily average turnover of the Hong Kong dollar system reached record highs during the year, mainly because of a number of well-received initial public offerings

in the stock market, which increased flows of Hong Kong dollars.

In 2006 the HKMA made encouraging progress in implementing the recommendations of the review of the financial infrastructure of Hong Kong conducted in 2005. Projects completed during the year include the CMU Bond Price Bulletin, the Renminbi Settlement System, and the payment-versus-payment link between Hong Kong's US dollar and Malaysia's ringgit RTGS systems.

Chart 1. Hong Kong dollar payment system daily average turnover

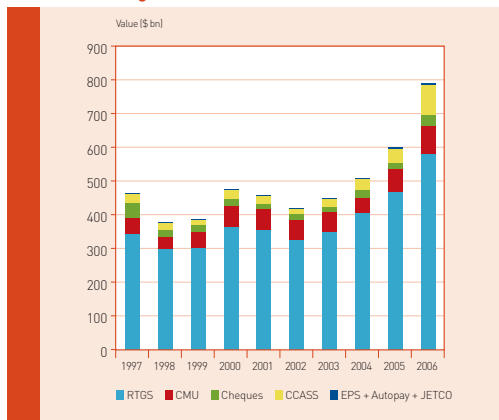


Chart 2. US dollar clearing system daily average turnover

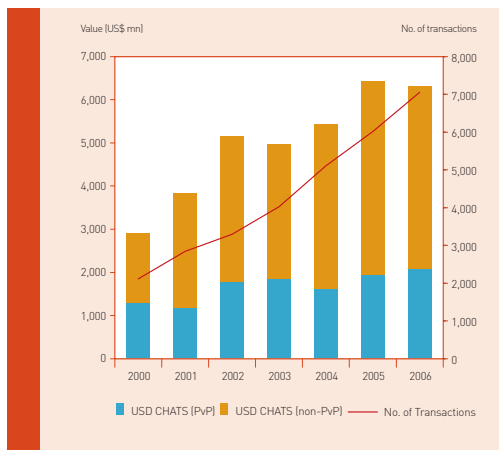


Chart 3. Euro clearing system daily average turnover



OVERSIGHT OF CLEARING AND SETTLEMENT SYSTEMS

In 2006 all designated systems under the *Clearing and Settlement Systems Ordinance* continued to be in compliance with the safety and efficiency requirements of the Ordinance. The HKMA assessed the Euro CHATS, one of the designated systems, and concluded that it generally observes the Core Principles for Systemically Important Payment Systems developed by the Committee on Payment and Settlement Systems of the Bank for International Settlements.

Assisted by the HKMA, eight credit and debit card scheme operators issued a *Code of Practice for Payment Card Scheme Operators* in December 2006. The Code sets out the principles on operational reliability, data and network security, and the efficiency and transparency of payment card operations in Hong Kong. The HKMA endorsed the Code and is responsible for monitoring the operators' compliance with it.

EXCHANGE FUND BILLS AND NOTES PROGRAMME

The HKMA completed a review of the programme in 2006. A number of recommendations to improve market efficiency were identified. Among these recommendations, a league table of the most active market makers was published for the first time in December. The HKMA has also removed the rule imposed in 1998 restricting the issuance of Hong Kong dollar bonds by multilateral development banks to tenors of three years or longer.

TREASURY MARKETS ASSOCIATION

The Association completed its first full year of operation. The HKMA continued to provide strategic support to develop Hong Kong into the hub of treasury market business in the region. More than 2,000 individual and 74 institutional members from virtually all sectors of the treasury markets have now joined the Association. To promote members' qualifications, new certificate programmes were developed jointly with the Hong Kong Institute of Bankers and the University of Science and Technology. The Association organised seminars, workshops and talks for market professionals, and launched new financial products to help develop the treasury markets.

 > Financial Infrastructure

International Financial Centre

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

The HKMA has enhanced its research and monitoring work on regional and Mainland economic and financial issues, with the aim of promoting greater financial stability in Asia including Hong Kong. It maintained contacts with the international central banking and financial community to promote international understanding of, and confidence in, Hong Kong's monetary and financial systems. Co-operation with Mainland authorities was also strengthened to promote further integration of the financial markets of the two places and to advance Hong Kong's status as an international financial centre for China. In 2006, the HKMA

- formulated a development strategy for enhancing the status of Hong Kong as an international financial centre through close financial co-operation with the Mainland
- pursued the expansion of the renminbi business in Hong Kong, as well as the use of Hong Kong's financial platform for orderly portfolio investment outflows from the Mainland

- continued to provide leadership and intellectual contributions to regional initiatives to strengthen co-operation in developing the bond market and enhancing monetary and financial stability in the region
- conducted in-depth research for further strengthening the monitoring work on Mainland and regional issues
- worked closely with Government bureaux to launch a targeted strategy towards international credit rating agencies in nurturing a better understanding of Hong Kong's economic and financial strengths.

THE 1-3-5 FINANCIAL DEVELOPMENT BLUEPRINT

In response to China's 11th Five-Year Plan promulgated in March, the HKMA proposed a blueprint to position Hong Kong as China's international financial centre. It is called "1-3-5" because it encompasses one strategic positioning, three institutional dimensions and five practical areas. The blueprint was adopted by the Focus Group on Financial Services set up by the Government under the HKSAR Chief Executive's Economic Summit on China's 11th Five-Year Plan and the Development of Hong Kong.

EXPANSION OF RENMINBI BUSINESS

Considerable progress was made in pursuing a further expansion of the renminbi business in Hong Kong. The State Council announced in January 2007 that financial institutions on the Mainland, subject to approval, can issue renminbi bonds in Hong Kong. This will bring a new asset class for investment by renminbi depositors in Hong Kong, and help the diversification of banks' assets and liabilities in renminbi. It is a further step forward in building up Hong Kong's capacity of conducting renminbi denominated transactions, which is important for Hong Kong to play an increasing role in financial intermediation on the Mainland and the use of the renminbi in international transactions.

UPGRADING HONG KONG'S SOVEREIGN CREDIT RATING

The HKMA worked with the Government to foster a better understanding of Hong Kong's economic and financial strengths among international credit rating agencies. The strategy proved to be effective and contributed to a number of upgrades in 2006, putting Hong Kong in the AA category by all major international rating agencies - the highest rating that has ever been assigned to Hong Kong. Standard and Poor's acknowledged in a study published in January 2007 that Hong Kong's credit strengths were comparable with those of many economies with AAA ratings.

RESEARCH ON MAINLAND ECONOMIC AND FINANCIAL ISSUES

The HKMA introduced a dedicated research series, *China Economic Issues*, in 2006 to complement the existing in-house monitoring and analytical work, as well as research exchanges with Mainland academics and think-tanks. The series provides detailed analysis of topics such as the Mainland's interest rate structure and the development of renminbi derivatives and commodity futures markets. Selected issues of *China Economic Issues* are available on the HKMA website www.hkma.gov.hk.

 > Monetary Stability > External Relations

 > China Economic Issues

Exchange Fund Performance in 2006

The Exchange Fund achieved an investment return of 9.5%, or 0.6% above that of the investment benchmark, in 2006. The Fund earned a gross investment income of \$103.8 billion, comprising

- \$31.9 billion from bond investments
- \$35.9 billion from Hong Kong equities
- \$18.7 billion from foreign equities
- a foreign exchange revaluation gain of \$17.3 billion.

Table 1. 2006 market returns

Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+11.8%
Yen	-0.9%
Bond markets	
US Government Bond (1-3 years) Index	+3.9%
Equity markets	
Standard & Poor's 500 Index	+13.6%
Hang Seng Index	+34.2%

Table 2. Gross investment return of the Exchange Fund in Hong Kong dollar terms¹

	Return on total assets	Return on investment benchmark ²	Alpha	CPI (A) ³
2006	9.5%	8.9%	+0.6%	+1.9%
2005	3.1%	2.9%	+0.2%	+1.3%
1999 – 2006				
annualised	6.2%	5.0%	+1.2%	-1.0%
1994 – 2006				
annualised	6.6%	N/A	N/A	+1.3%

¹ For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US dollar terms.

² Established in January 1999.

³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 2004/2005 base new series.

Table 3. Currency mix of the Exchange Fund's assets on 31 December 2006 – including forward transactions

	HK\$ billion	%
US dollar bloc		
US dollar ¹	909.8	77.4
Hong Kong dollar	130.9	11.1
Non-US dollar bloc	135.7	11.5
Total	1,176.4	100.0

¹ Includes Canadian dollar, Australian dollar and New Zealand dollar.

Since 1994, the Exchange Fund has generated a compounded annual return of 6.6%, which exceeds the compounded annual inflation rate of 1.3% over the period. The investment return of the Exchange Fund has exceeded the

benchmark return in every year for the past eight years, except in 2004 when the actual investment return was the same as the benchmark return.

 > Monetary Stability > Exchange Fund

Chart 1. Investment return of the Exchange Fund (1994-2006)

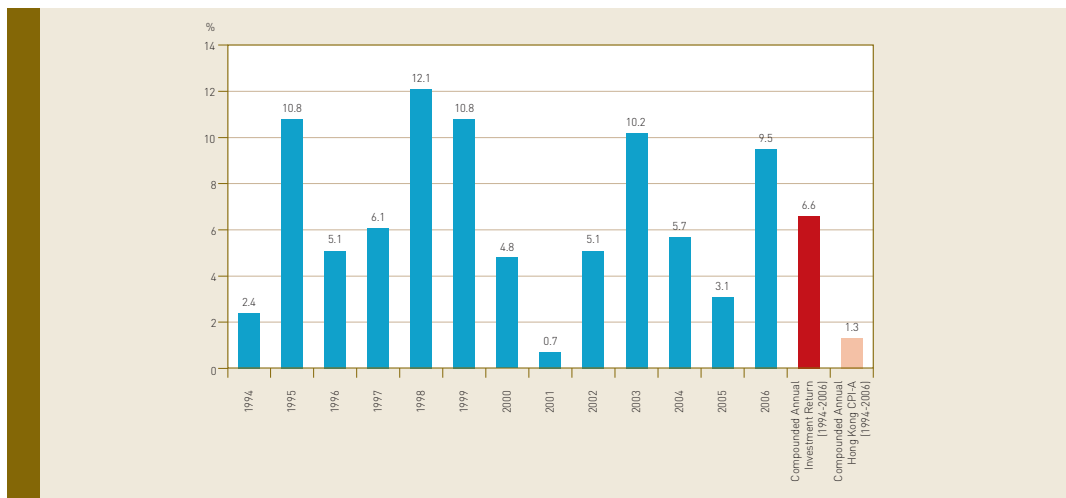
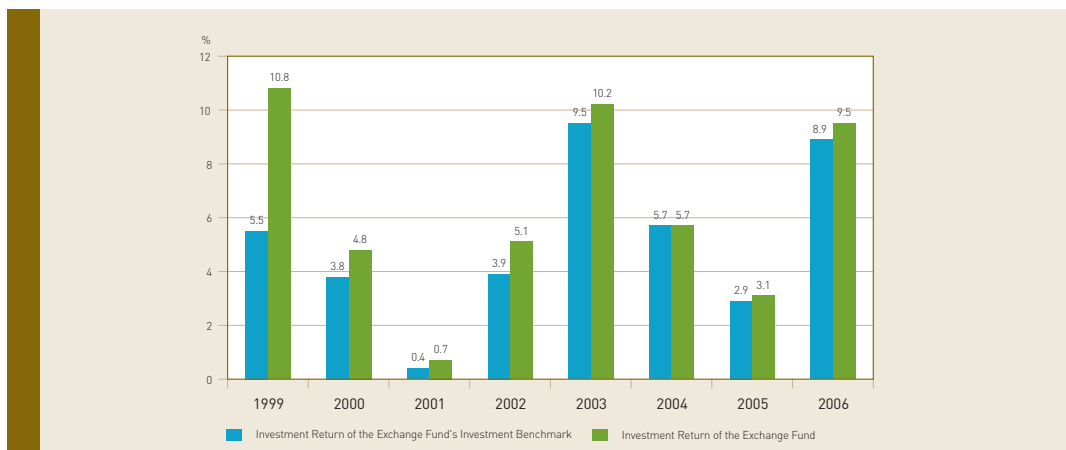


Chart 2. Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2006)



The Exchange Fund

The audited full statement of accounts of the Exchange Fund for 2006 may be found in the HKMA Annual Report 2006.

EXCHANGE FUND - INCOME AND EXPENDITURE ACCOUNT

for the year ended 31 December 2006

	Group		Fund	
	2006	2005 (restated)	2006	2005
(Expressed in millions of Hong Kong dollars)				
INCOME				
Interest income	43,483	31,496	41,184	29,719
Dividend income	6,162	5,165	6,429	5,430
Net realised and revaluation gains	38,799	22,173	38,806	22,182
Net exchange gains/(losses)	17,360	(19,468)	17,338	(19,474)
Investment income	105,804	39,366	103,757	37,857
Bank licence fees	132	129	132	129
Other income	277	269	64	36
TOTAL INCOME	106,213	39,764	103,953	38,022
EXPENDITURE				
Interest expense	(38,996)	(17,137)	(37,421)	(16,026)
Operating expenses	(1,986)	(1,628)	(1,810)	(1,463)
Note and coin expenses	(160)	(208)	(160)	(208)
Write back of impairment losses on loans	8	19	-	-
TOTAL EXPENDITURE	(41,134)	(18,954)	(39,391)	(17,697)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE	65,079	20,810	64,562	20,325
Share of profit of associate, net of tax	8	3	-	-
SURPLUS BEFORE TAXATION	65,087	20,813	64,562	20,325
Income tax	(86)	(100)	-	-
SURPLUS FOR THE YEAR	65,001	20,713	64,562	20,325
ATTRIBUTABLE TO:				
Owner of the Fund	64,987	20,690	64,562	20,325
Minority interests	14	23	-	-
	65,001	20,713	64,562	20,325

EXCHANGE FUND - BALANCE SHEET

as at 31 December 2006

	Group		Fund	
	2006	2005 (restated)	2006	2005
(Expressed in millions of Hong Kong dollars)				
ASSETS				
Cash and money at call	19,726	15,937	19,661	15,887
Placements with banks and other financial institutions	44,670	75,667	42,766	73,120
Derivative financial instruments	1,490	1,953	1,227	1,865
Financial assets designated at fair value through profit or loss	1,088,192	953,145	1,088,192	953,145
Available-for-sale securities	5,107	2,483	493	493
Held-to-maturity securities	4,753	4,585	-	-
Loan portfolio	32,394	33,549	-	-
Gold	330	266	330	266
Other assets	18,926	17,023	17,949	16,149
Investments in subsidiaries	-	-	2,145	2,145
Interest in associate	35	26	-	-
Property, plant and equipment	853	888	611	625
Operating land lease prepayment	2,997	3,071	2,997	3,071
Intangible assets	22	33	22	33
TOTAL ASSETS	1,219,495	1,108,626	1,176,393	1,066,799
LIABILITIES AND EQUITY				
Certificates of Indebtedness	156,926	148,406	156,926	148,406
Government-issued currency notes and coins in circulation	6,842	6,671	6,842	6,671
Balance of the banking system	2,035	1,561	2,035	1,561
Derivative financial instruments	735	869	572	525
Trading liabilities	2,096	7,412	2,096	7,412
Placements by banks and other financial institutions	7,572	25,712	7,572	25,712
Placements by other Hong Kong Special Administrative Region government funds	324,530	297,086	324,530	297,086
Placements by Hong Kong statutory bodies	26	-	26	-
Exchange Fund Bills and Notes issued	129,139	118,134	129,139	118,134
Other debt securities issued	28,910	27,991	-	-
Mortgage-backed securities issued	5,341	5,145	-	-
Other liabilities	44,231	23,541	38,947	18,146
Total liabilities	708,383	662,528	668,685	623,653
Accumulated surplus	510,813	445,826	507,708	443,146
Available-for-sale securities revaluation reserve	125	94	-	-
Total equity attributable to owner of the Fund	510,938	445,920	507,708	443,146
Minority interests	174	178	-	-
Total equity	511,112	446,098	507,708	443,146
TOTAL LIABILITIES AND EQUITY	1,219,495	1,108,626	1,176,393	1,066,799

Major Events 1993-2006

1993

April 1993

The HKMA is established with responsibility for monetary and banking stability, reserves management, and financial infrastructure.



May 1993

The Government starts to replace the Queen's Head coins with those using the new bauhinia design.

July 1993

The Government announces the sale of Overseas Trust Bank for \$4,457 million. The sale of the bank, taken over in June 1985, marks the end of the Government's efforts to rescue banks in the 1980s.



1994

May 1994

The Bank of China issues its first Hong Kong banknotes.



August 1994

The Hang Seng China Enterprises Index is launched to serve as an indicator of the overall performance of Hong Kong-listed, state owned enterprises of the People's Republic of China.

September 1994

The first issue of five-year Exchange Fund Notes is launched. The issue helps extend the benchmark yield curve for Hong Kong dollar debt to the five-year area.

October 1994

The interest rate cap on time deposits is lifted in phases. This marks the beginning of a relaxation of Interest Rate Rules in Hong Kong.

November 1994

Hong Kong issues its first bimetallic coin – the bauhinia \$10 coin.



1995

May 1995

Hong Kong Interbank Clearing Limited is established to provide interbank clearing services in Hong Kong.



June 1995

The HKMA becomes the licensing authority of three types of authorized institutions, following the enactment of the Banking (Amendment) Ordinance 1995.

July 1995

The Companies Ordinance is amended. Depositors are entitled to receive priority payment in the liquidation of banks.

November 1995

The Government decides to publish the size of Hong Kong's foreign exchange reserves (i.e. foreign currency assets of the Exchange Fund) every quarter instead of every six months.

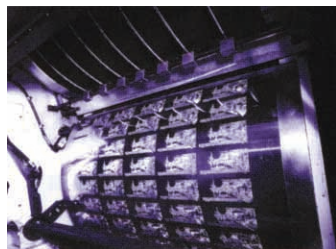
November 1995

The first issue of seven-year Exchange Fund Notes is launched.

1996

January 1996

The Exchange Fund acquires the De La Rue banknote printing plant in Tai Po, which is renamed "Hong Kong Note Printing Limited".



September 1996

The HKMA is invited to join the Bank for International Settlements, the Swiss-based forum promoting co-operation among central banks.

October 1996

The first issue of ten-year Exchange Fund Notes is launched.

December 1996

Real Time Gross Settlement is launched in Hong Kong, enabling interbank payments to be settled in real time.

1997

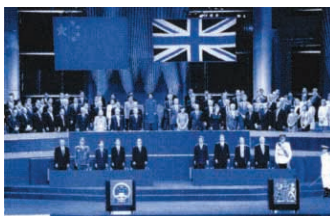
March 1997

The Hong Kong Mortgage Corporation is established. It buys mortgage loans for its own portfolio and issue mortgage-backed securities.



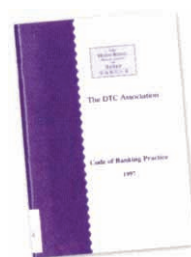
July 1997

Hong Kong becomes a Special Administrative Region of the People's Republic of China.



July 1997

The *Code of Banking Practice* is issued to improve the transparency and quality of banking services in Hong Kong.



July 1997

The assets of the Land Fund are handed over to Hong Kong SAR Government with a net value of \$197 billion. From July 1997 to October 1998 these assets are managed by the HKMA as a separate fund within the fiscal reserves. On 1 November 1998 the assets of the Land Fund are merged with the Exchange Fund and managed as part of the investment portfolio of the Exchange Fund.

September 1997

World Bank/IMF Annual Meetings are held in Hong Kong. Central bank and finance ministry officials from some 180 countries attend the meetings.



1998

July 1998

Hong Kong International Airport opens at Chek Lap Kok.



July 1998

The Bank for International Settlements opens its representative office for Asia and the Pacific in Hong Kong.

August 1998

Using \$118 billion from the Exchange Fund, the Hong Kong SAR Government launches a stock market operation to frustrate manipulation of the money and stock markets.

September 1998

The HKMA introduces seven technical measures to strengthen the Currency Board arrangements.



October 1998

Exchange Fund Investment Limited is established to manage the portfolio of Hang Seng Index constituent stocks acquired by the Exchange Fund in the market operation of August.

1999

January 1999

The foreign currency assets and the balance sheet data of the Exchange Fund are published monthly, in line with the standard set by the International Monetary Fund.

August 1999

Exchange Fund Notes commence listing on the Hong Kong Stock Exchange.

August 1999

The Hong Kong Institute for Monetary Research is established.



November 1999

The Tracker Fund of Hong Kong is established as a vehicle for gradually disposing of the majority of the stocks acquired by the Exchange Fund in the 1998 market operation.



2000

August 2000

Hong Kong processes its first transaction through the new US dollar clearing system.

October 2000

Hong Kong is selected as President for 2001-2002 of the Financial Action Task Force on Money Laundering, an international body.

December 2000

Hong Kong's Mandatory Provident Fund System comes into full operation.

2001

January 2001

The International Monetary Fund opens a sub-office in Hong Kong.

April 2001

The Government approves in principle the proposal to introduce a deposit protection scheme in Hong Kong.

July 2001

Interest Rate Rules are completely deregulated. Banks are free to set interest rates for all types of deposits.

November 2001

All restrictions on the number of branches of foreign banks are lifted.

December 2001

China enters the World Trade Organization.

2002

March 2002

The Securities and Futures Ordinance is passed by the Legislative Council. The Ordinance consolidates and modernises 10 existing ordinances into a single piece of legislation to govern financial and investment products, regulate the securities and futures markets, and protect investors.

May 2002

The Government endorses the HKMA's proposals to relax certain market entry criteria for the banking sector.

September 2002

The Government issues new \$10 currency notes.



2003

March to June 2003

Outbreak of Severe Acute Respiratory Syndrome. 1,755 people in Hong Kong are infected and 299 people die.

April 2003

Hong Kong processes its first transaction through its new euro clearing system.

June 2003

Exchange of letters between the Financial Secretary and the Monetary Authority on functions and responsibilities in monetary and financial affairs.

June 2003

The Mainland and Hong Kong sign the Closer Economic Partnership Arrangement.



December 2003

The three note-issuing banks issue new \$100 and \$500 notes with additional security features.



2004

February 2004

Over 30 banks in Hong Kong introduce renminbi deposit, exchange, remittance, and debit and credit card services.

May 2004

The Deposit Protection Scheme Ordinance is enacted.

July 2004

The Clearing and Settlement Systems Ordinance is enacted.

October 2004

The three note-issuing banks issue new \$20, \$50 and \$1000 notes with additional security features.



November 2004

The Commercial Credit Reference Agency is launched.

2005

May 2005

The HKMA announces three refinements to the operation of the Linked Exchange Rate system.

July 2005

The Banking (Amendment) Ordinance 2005 is passed to provide a legislative framework for the implementation of Basel II in Hong Kong.

July 2005

The People's Bank of China announces reform of the renminbi exchange rate regime.

December 2005

The Sixth Ministerial Conference of the World Trade Organization takes place in Hong Kong.

2006

March 2006

The Renminbi Settlement System is launched. The system provides a safe and efficient clearing and settlement platform to support the further expansion of renminbi business in Hong Kong.

September 2006

The Hong Kong banking industry implements a five-day clearing week.

September 2006

The Deposit Protection Scheme commences operation. The Scheme provides a measure of protection to depositors and contributes to the stability of the financial system.

Abbreviations

AI	-	Authorized institution
AML	-	Anti-money-laundering
CFT	-	Counter-terrorist-financing
CHATS	-	Clearing House Automated Transfer System
CMU	-	Central Moneymarkets Unit
CPI	-	Consumer Price Index
DTC	-	Deposit-taking companies
EFAC	-	Exchange Fund Advisory Committee
GDP	-	Gross Domestic Product (in real terms unless otherwise stated)
HIBOR	-	Hong Kong Interbank Offer Rate
HK	-	Hong Kong
HKMA	-	Hong Kong Monetary Authority
IMF	-	International Monetary Fund
IRB approach	-	Internal Ratings-based approach
LIBOR	-	London Interbank Offer Rate
N.A.	-	Not applicable
PvP	-	Payment-versus-Payment
RMB	-	Renminbi
RTGS	-	Real Time Gross Settlement
SAR	-	Special Administrative Region
US	-	United States of America

Reference Resources

The *HKMA Annual Report* is published in April or May each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

HKMA Quarterly Bulletin

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (on-line 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)

HKMA Background Brief No. 2 - Banking Supervision in Hong Kong

HKMA Background Brief No. 3 - Mandate and Governance of the Hong Kong Monetary Authority

HKMA Background Brief No. 4 - Financial Infrastructure 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.

 > [HKMA Information Centre](#)

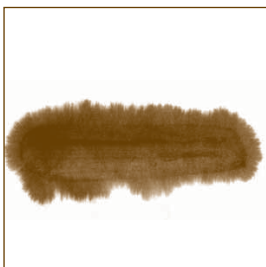
Most HKMA publications are also available for downloading free of charge from the HKMA website (www.hkma.gov.hk). A mail order form for the purchase of print publications can be found on the website.

 > [Publications](#)

The main texts of the regular briefings by the HKMA to the Legislative Council Panel on Financial Affairs are available online.

 > [Legislative Council Issues](#)

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.



The theme of this Annual Report is the five elements of Chinese philosophy – water, wood, fire, earth and gold. The five elements, presented symbolically, suggest tradition, balance, harmony and the operation of an ordered system.

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