

THE EXCHANGE FUND

- Report of the Director of Audit to the Financial Secretary
- 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 TO THE FINANCIAL SECRETARY

I have audited the statement of the accounts on pages 98 to 173 which has been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of the Monetary Authority and the Director of Audit

The directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance (Cap. 66) requires the Monetary Authority to sign the statement of the accounts. In preparing the statement of the accounts, the Monetary Authority has to select appropriate accounting policies and to apply them consistently.

It is my responsibility to form an independent opinion, based on my audit, on that statement of the accounts and to report my opinion to you.

Basis of opinion

I certify that I have audited the statement of the accounts referred to above in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance and the Audit Commission auditing standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the statement of the accounts. It also includes an assessment of the significant estimates and judgements made by the Monetary Authority in the preparation of the statement of the accounts, and of whether the accounting policies are appropriate to the Exchange Fund's and the Group's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance as to whether the statement of the accounts is free from material misstatement. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the statement of the accounts. I believe that my audit provides a reasonable basis for my opinion.

Opinion

In my opinion the statement of the accounts gives a true and fair view of the state of affairs of the Exchange Fund and of the Group as at 31 December 2005 and of their surplus and cash flows for the year then ended and has been properly prepared in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance.

Audit Commission
Hong Kong
30 March 2006

(Benjamin Tang)
Director of Audit

EXCHANGE FUND - INCOME AND EXPENDITURE ACCOUNT

for the year ended 31 December 2005

		Group		Fund	
		2005	2004	2005	2004
(Expressed in millions of Hong Kong dollars)	Notes		(restated)		(restated)
INCOME					
Interest income		31,307	24,598	29,719	23,574
Dividend income		5,165	4,556	5,430	4,573
Net realised and revaluation gains		22,173	20,120	22,182	20,120
Net exchange gains/(losses)		(19,468)	8,469	(19,474)	8,474
Investment income	4(a)	39,177	57,743	37,857	56,741
Bank licence fees		129	129	129	129
Other income		308	353	36	70
TOTAL INCOME		39,614	58,225	38,022	56,940
EXPENDITURE					
Interest expense	4(b)	(16,990)	(18,066)	(16,026)	(17,856)
Operating expenses	4(c)	(1,626)	(1,454)	(1,463)	(1,271)
Note and coin expenses	4(d)	(208)	(182)	(208)	(182)
Write back of impairment losses on loans/ (Provisions made for bad and doubtful loans)	4(e)	19	(89)	-	-
TOTAL EXPENDITURE		(18,805)	(19,791)	(17,697)	(19,309)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE		20,809	38,434	20,325	37,631
Share of profit of associate, net of tax		3	3	-	-
SURPLUS BEFORE TAXATION		20,812	38,437	20,325	37,631
Income tax		(100)	(109)	-	-
SURPLUS FOR THE YEAR		20,712	38,328	20,325	37,631
ATTRIBUTABLE TO:					
Owner of the Fund		20,689	38,307	20,325	37,631
Minority interests		23	21	-	-
		20,712	38,328	20,325	37,631

The notes on pages 103 to 173 form part of these accounts.

EXCHANGE FUND - BALANCE SHEET

as at 31 December 2005

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2005	2004 (restated)	2005	2004 (restated)
ASSETS					
Cash and money at call	6	15,937	20,759	15,887	20,738
Placements with banks and other financial institutions	7	75,648	48,178	73,120	42,747
Derivative financial instruments	8(a)	1,950	1,438	1,865	1,438
Financial assets designated at fair value through profit or loss	9(a)	953,145	–	953,145	–
Other investments in securities	9(b)	–	977,746	–	977,746
Available-for-sale securities	10(a)	2,483	–	493	–
Investment securities	10(b)	–	300	–	300
Held-to-maturity securities	11	4,605	4,130	–	–
Mortgage loans	12	29,476	34,938	–	–
Gold	13	266	228	266	228
Other assets	14	17,015	13,398	16,149	12,476
Investments in subsidiaries	15	–	–	2,145	2,145
Investment in associate	16	26	23	–	–
Property, plant and equipment	17	888	885	625	635
Operating land lease prepayment	18	3,071	3,145	3,071	3,145
Intangible assets	19	33	42	33	42
TOTAL ASSETS		1,104,543	1,105,210	1,066,799	1,061,640
LIABILITIES AND EQUITY					
Certificates of Indebtedness	20	148,406	146,775	148,406	146,775
Government-issued currency notes and coins in circulation	20	6,671	6,351	6,671	6,351
Balance of the banking system	21	1,561	15,789	1,561	15,789
Derivative financial instruments	8(a)	834	2,372	525	2,372
Trading liabilities		7,412	100	7,412	100
Placements by banks and other financial institutions	22	25,712	39,087	25,712	39,087
Placements by other Hong Kong Special Administrative Region government funds	23	297,086	280,091	297,086	280,091
Exchange Fund Bills and Notes issued	24	118,134	125,860	118,134	125,860
Other debt securities issued	25	27,991	35,495	–	–
Other liabilities	26	24,636	27,499	18,146	21,838
Total liabilities		658,443	679,419	623,653	638,263
Accumulated surplus	27	445,828	425,624	443,146	423,377
Available-for-sale securities revaluation reserve	27	94	–	–	–
Total equity attributable to owner of the Fund		445,922	425,624	443,146	423,377
Minority interests	27	178	167	–	–
Total equity		446,100	425,791	443,146	423,377
TOTAL LIABILITIES AND EQUITY		1,104,543	1,105,210	1,066,799	1,061,640

Joseph Yam
Monetary Authority
30 March 2006

The notes on pages 103 to 173 form part of these accounts.

EXCHANGE FUND - STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2005

[Expressed in millions of Hong Kong dollars]	NOTES	Group			2004 (restated)			Fund	
		2005			2005	2004 (restated)		2005	2004 (restated)
		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		425,838	-	425,838	386,450	-	386,450	423,591	384,879
Reclassification of minority interests to equity		-	167	167	-	160	160	-	-
Prior year adjustment arising from changes in accounting policies under HKAS 16 and 17	27	(214)	-	(214)	867	-	867	(214)	867
As restated before opening balance adjustment		425,624	167	425,791	387,317	160	387,477	423,377	385,746
Opening balance adjustment arising from changes in accounting policies under HKAS 39	27	(485)	-	(485)	-	-	-	(556)	-
Total equity at 1 January, after prior year and opening balance adjustments	27	425,139	167	425,306	387,317	160	387,477	422,821	385,746
Fair value gains on available-for-sale securities									
Net gains recognised directly in equity	27	87	-	87	-	-	-	-	-
Net losses transferred to income and expenditure account on disposal	27	7	-	7	-	-	-	-	-
		94	-	94	-	-	-	-	-
Surplus for the year									
As previously reported					39,203	-	39,203		38,527
Reclassification of minority interests to equity	3.1.1				-	21	21		-
Prior year adjustment arising from changes in accounting policies under HKAS 16 and 17	3.1.1				(896)	-	(896)		(896)
Surplus for the year (2004: as restated)	27	20,689	23	20,712	38,307	21	38,328	20,325	37,631
Dividends paid to minority interests	27	-	(12)	(12)	-	(14)	(14)	-	-
Total equity at 31 December	27	445,922	178	446,100	425,624	167	425,791	443,146	423,377

The notes on pages 103 to 173 form part of these accounts.

EXCHANGE FUND - CASH FLOW STATEMENT

for the year ended 31 December 2005

		Group		Fund	
		2005	2004	2005	2004
(Expressed in millions of Hong Kong dollars)	Notes		(restated)		(restated)
Cash flows from operating activities					
Surplus before share of profit of associate		20,809	38,434	20,325	37,631
Adjustments for:					
Interest income	4(a)	(31,307)	(24,598)	(29,719)	(23,574)
Dividend income	4(a)	(5,165)	(4,556)	(5,430)	(4,573)
Net losses on disposal of available-for-sale securities	4(a)	7	–	–	–
Interest expense	4(b)	16,990	18,066	16,026	17,856
Depreciation and amortisation	4(c)	147	155	116	120
Elimination of exchange differences and other non-cash items		1,990	(1,062)	2,068	(1,117)
Interest received		31,478	24,487	29,889	23,435
Interest paid		(21,379)	(29,328)	(20,424)	(29,088)
Dividends received		5,156	4,512	5,156	4,512
Tax paid		(161)	(80)	–	–
		18,565	26,030	18,007	25,202
Change in placements with banks and other financial institutions		12	3,995	3	4,015
Change in fair value of derivatives and other debt securities issued		(2,310)	–	(2,324)	–
Change in financial assets designated at fair value through profit or loss		40,740	–	40,740	–
Change in other investments in securities		–	(57,567)	–	(57,567)
Change in mortgage loans		5,739	(389)	–	–
Change in gold		(38)	(11)	(38)	(11)
Change in other assets		(5,439)	(276)	(5,329)	(227)
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		2,487	12,614	2,487	12,614
Change in balance of the banking system		(14,228)	(12,488)	(14,228)	(12,488)
Change in trading liabilities		5,820	–	5,820	–
Change in placements by banks and other financial institutions		(13,362)	(5,455)	(13,362)	(5,455)
Change in placements by other Hong Kong Special Administrative Region government funds		16,995	27,795	16,995	27,795
Change in placements by Hong Kong statutory bodies		–	(164)	–	(164)
Change in Exchange Fund Bills and Notes issued		(4,951)	2,340	(4,951)	2,340
Change in other liabilities		1,594	2,592	734	(1,913)
Net cash from/(used in) operating activities		51,624	(984)	44,554	(5,859)

EXCHANGE FUND - CASH FLOW STATEMENT (cont.)

for the year ended 31 December 2005

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2005	2004 (restated)	2005	2004 (restated)
Cash flows from investing activities					
Proceeds from sale of available-for-sale securities		2,217	–	–	–
Purchase of available-for-sale securities		(4,287)	–	(193)	–
Proceeds from sale or redemption of held-to-maturity securities		5,644	1,198	–	–
Purchase of held-to-maturity securities		(6,125)	(1,762)	–	–
Purchase of property, plant and equipment and intangible assets		(69)	(52)	(25)	(25)
Dividends received from subsidiaries		–	–	265	17
Net cash from/(used in) investing activities		(2,620)	(616)	47	(8)
Cash flows from financing activities					
Proceeds from issue of other debt securities		5,091	11,409	–	–
Redemption of other debt securities issued		(12,348)	(12,524)	–	–
Dividends paid to minority shareholders		(12)	(14)	–	–
Net cash used in financing activities		(7,269)	(1,129)	–	–
Net increase/(decrease) in cash and cash equivalents		41,735	(2,729)	44,601	(5,867)
Cash and cash equivalents at 1 January		178,852	180,469	173,420	178,170
Effect of foreign exchange rate changes		(2,065)	1,112	(2,068)	1,117
Cash and cash equivalents at 31 December	28	218,522	178,852	215,953	173,420

The notes on pages 103 to 173 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, its subsidiaries and its 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 29.

2. Significant Accounting Policies

2.1 Statement of compliance

These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (HKFRSs), which collective term 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 a number of new and revised HKFRSs that are effective or available for early adoption for accounting periods beginning on or after 1 January 2005 (note 38). Information on the changes in accounting policies resulting from initial application of these new and revised HKFRSs for the current and prior accounting periods reflected in these financial statements is provided in note 3.

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 reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical 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 36 contains information about the assumptions and risk factors relating to fair value 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 in which the Group, directly or indirectly, holds more than half of the issued share capital or controls more than half the voting power or controls the composition of the board of directors. Subsidiaries are considered to be controlled if the Fund has the power, directly or indirectly, to govern the financial and operating policies, so as to obtain benefits from their activities.

Special Purpose Entities (SPEs) as disclosed in note 34 established in prior years in connection with securitisation programmes are not consolidated as they do not meet the definition of subsidiary in the Hong Kong Companies Ordinance.

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

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

Minority interests at the balance sheet date, being the portion of the net assets of subsidiaries attributable to equity interests that are not owned by the Fund, are presented in the consolidated balance sheet and statement of changes in equity 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 consolidated 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's 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 over which 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 consolidated 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 consolidated 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's 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 be 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 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 not subject to short term price fluctuations, and are therefore 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 do not qualify for hedge accounting but are managed and whose performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy; and
- debt securities issued by the Fund’s subsidiary, The Hong Kong Mortgage Corporation Limited (HKMC), which include embedded derivatives where the characteristics and risks of the embedded derivatives are not closely related to the host 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 mortgage loans 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.

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

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

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 foreign exchange gains and losses 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 which are released from equity to the income and expenditure account.

2.5.2.6 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 issue with US dollars, the issue and the withdrawal 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.

2.5.2.7 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 HKSAR government funds with fixed maturity and certain debt securities (other than those which contain embedded derivatives) issued by the HKMC.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

Other financial liabilities repayable on demand are stated at the principal amount payable.

These include placements by other HKSAR government funds which are repayable on demand and the balance of the banking system.

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 the 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 profit or loss on derecognition.

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 as 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 offset 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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

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 of 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 is recognised as interest income or interest expense, over the life of each agreement using the effective interest method.

2.7 Securities lending agreements

Where securities are loaned with the receipt of cash or securities as collateral, they are retained on the balance sheet and measured in accordance with 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 liabilities 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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

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.

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 profit or loss – is removed from equity and recognised in the income and expenditure account. Such impairment losses 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 for debt securities are recognised in the income and expenditure account. Reversals of impairment losses for equity securities are recognised directly in equity.

For available-for-sale equity securities carried at cost, the amount of 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 could 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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

Depreciation is calculated to write off the cost of items of property, plant and equipment 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

Subsequent expenditure relating to an item of property, plant and equipment that has already been recognised is added to the carrying amount of the asset when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the Group. All other subsequent expenditure is recognised as an expense in the period in which it is incurred.

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.

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 depreciation and any impairment losses (note 2.14). The land element is depreciated 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 the 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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

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.

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.

For impaired mortgage loans, the accrual of interest income based on the original terms of the loan is discontinued, but any increase in the present value of impaired loans due to the passage of time is reported as interest income.

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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

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 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 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.

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 prevailing 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 at the exchange rates prevailing at the transaction dates. Non-monetary assets and liabilities that are measured at fair value are translated into Hong Kong dollars using the exchange rates 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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

2.18 Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals or entities and include entities which are under the significant influence of related parties of the Group where those parties are individuals.

2.19 Segment reporting

The activities of the Fund managed by the Hong Kong Monetary Authority (HKMA) 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 financial and banking system of Hong Kong, including banking supervision, monetary management and the activities of the subsidiaries.

Details are set out in note 29. 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 a number of new and revised HKFRSs that are effective for accounting periods beginning on or after 1 January 2005.

The accounting policies of the Group and/or the Fund after the adoption of these new and revised HKFRSs have been summarised in note 2. The following sets out information on the significant changes in accounting policies for the current and prior accounting periods reflected in these financial statements.

Except for two amendments to HKAS 39, the Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (note 38).

3.1 Restatement of prior period and opening balances

The following tables disclose the adjustments that have been made in accordance with the transitional provisions of the respective HKFRSs to each of the line items in the income and expenditure account and balance sheet as previously reported for the year ended 31 December 2004. The effects of the changes in accounting policies on equity at 1 January 2004 and 2005 are disclosed in note 27.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

3.1.1 Effect on the income and expenditure account for the year ended 31 December 2004

	2004 (as previously reported)	Group Effect of new policy (increase/(decrease) in surplus for the year)		2004 (restated)
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)	
INCOME				
Interest income	24,598	–	–	24,598
Dividend income	4,556	–	–	4,556
Net realised and revaluation gains	20,120	–	–	20,120
Net exchange gains	8,469	–	–	8,469
Bank licence fees	129	–	–	129
Other income	353	–	–	353
TOTAL INCOME	58,225	–	–	58,225
EXPENDITURE				
Interest expense	(18,066)	–	–	(18,066)
Operating expenses	(1,523)	89	(20)	(1,454)
Note and coin expenses	(182)	–	–	(182)
Provisions made for bad and doubtful loans	–	(89)	–	(89)
TOTAL EXPENDITURE	(19,771)	–	(20)	(19,791)
SURPLUS BEFORE PREMISES REVALUATION AND SHARE OF PROFIT OF ASSOCIATE	38,454	–	(20)	38,434
Surplus on revaluation of premises	876	–	(876)	–
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE	39,330	–	(896)	38,434
Share of profit of associate	4	(1)	–	3
SURPLUS BEFORE TAXATION	39,334	(1)	(896)	38,437
Income tax	(110)	1	–	(109)
SURPLUS AFTER TAXATION	39,224	–	(896)	38,328
Minority interests	(21)	21	–	–
SURPLUS FOR THE YEAR	39,203	21	(896)	38,328
ATTRIBUTABLE TO:				
Owner of the Fund	39,203	–	(896)	38,307
Minority interests	–	21	–	21
	39,203	21	(896)	38,328

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

	2004 (as previously reported)	Fund Effect of new policy (increase/ (decrease) in surplus for the year)	2004 (restated)
		HKAS 16 & 17 (note 3.5)	
INCOME			
Interest income	23,574	–	23,574
Dividend income	4,573	–	4,573
Net realised and revaluation gains	20,120	–	20,120
Net exchange gains	8,474	–	8,474
Bank licence fees	129	–	129
Other income	70	–	70
TOTAL INCOME	56,940	–	56,940
EXPENDITURE			
Interest expense	(17,856)	–	(17,856)
Operating expenses	(1,251)	(20)	(1,271)
Note and coin expenses	(182)	–	(182)
TOTAL EXPENDITURE	(19,289)	(20)	(19,309)
SURPLUS BEFORE PREMISES REVALUATION	37,651	(20)	37,631
Surplus on revaluation of premises	876	(876)	–
SURPLUS FOR THE YEAR ATTRIBUTABLE TO OWNER OF THE FUND	38,527	(896)	37,631

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

3.1.2 Effect on the balance sheet at 31 December 2004 and 1 January 2005

				Group			
	2004 (as previously reported)	Effect of new policy (increase/(decrease) in total assets and total liabilities)		2004 (restated)	HKAS 39 Re- designation (note 3.3)	HKAS 39 Measurement (increase/ (decrease) in total assets and total liabilities) (note 3.3)	Opening balance at 1 January 2005
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)				
ASSETS							
Cash and money at call	20,759	–	–	20,759	–	–	20,759
Placements with banks and other financial institutions	48,178	–	–	48,178	–	3	48,181
Derivative financial instruments	–	1,438	–	1,438	–	876	2,314
Financial assets designated at fair value through profit or loss	–	–	–	–	977,416	(544)	976,872
Other investments in securities	977,746	–	–	977,746	(976,431)	(1,315)	–
Available-for-sale securities	–	–	–	–	300	–	300
Investment securities	300	–	–	300	(300)	–	–
Held-to-maturity securities	4,130	–	–	4,130	–	–	4,130
Mortgage loans	34,938	–	–	34,938	–	54	34,992
Gold	228	–	–	228	–	–	228
Other assets	14,510	(1,112)	–	13,398	(985)	(568)	11,845
Investment in associate	23	–	–	23	–	–	23
Fixed assets	4,286	(4,286)	–	–	–	–	–
Property, plant and equipment	–	4,244	(3,359)	885	–	–	885
Operating land lease prepayment	–	–	3,145	3,145	–	–	3,145
Intangible assets	–	42	–	42	–	–	42
TOTAL ASSETS	1,105,098	326	(214)	1,105,210	–	(1,494)	1,103,716

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

				Group			
	2004 (as previously reported)	Effect of new policy (increase/(decrease) in total assets and total liabilities)		2004 (restated)	HKAS 39 Re- designation (note 3.3)	HKAS 39 Measurement (increase/ (decrease) in total assets and total liabilities) (note 3.3)	Opening balance at 1 January 2005
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)				
LIABILITIES AND EQUITY							
Certificates of Indebtedness	146,775	–	–	146,775	–	(514)	146,261
Government-issued currency notes and coins in circulation	6,351	–	–	6,351	–	(22)	6,329
Balance of the banking system	15,789	–	–	15,789	–	–	15,789
Derivative financial instruments	–	2,372	–	2,372	–	14	2,386
Trading liabilities	–	100	–	100	–	1,491	1,591
Placements by banks and other financial institutions	39,087	–	–	39,087	–	(13)	39,074
Placements by other HKSAR government funds	280,091	–	–	280,091	–	–	280,091
Exchange Fund Bills and Notes issued	125,860	–	–	125,860	–	(2,775)	123,085
Other debt securities issued	35,495	–	–	35,495	–	830	36,325
Other liabilities	29,645	(2,146)	–	27,499	–	(20)	27,479
Total liabilities	679,093	326	–	679,419	–	(1,009)	678,410
Accumulated surplus	425,644	–	(20)	425,624	–	(485)	425,139
Premises revaluation reserve	194	–	(194)	–	–	–	–
Total equity attributable to owner of the Fund	425,838	–	(214)	425,624	–	(485)	425,139
Minority interests	–	167	–	167	–	–	167
Total equity	425,838	167	(214)	425,791	–	(485)	425,306
Minority interests	167	(167)	–	–	–	–	–
TOTAL LIABILITIES AND EQUITY	1,105,098	326	(214)	1,105,210	–	(1,494)	1,103,716

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

				Fund			
	2004 (as previously reported)	Effect of new policy (increase/(decrease) in total assets and total liabilities)		2004 (restated)	HKAS 39 Re- designation (note 3.3)	HKAS 39 Measurement (increase/ (decrease) in total assets and total liabilities) (note 3.3)	Opening balance at 1 January 2005
		HKAS 1 (note 3.4)	HKAS 16 & 17 (note 3.5)				
ASSETS							
Cash and money at call	20,738	–	–	20,738	–	–	20,738
Placements with banks and other financial institutions	42,747	–	–	42,747	–	3	42,750
Derivative financial instruments	–	1,438	–	1,438	–	–	1,438
Financial assets designated at fair value through profit or loss	–	–	–	–	977,416	(544)	976,872
Other investments in securities	977,746	–	–	977,746	(976,431)	(1,315)	–
Available-for-sale securities	–	–	–	–	300	–	300
Investment securities	300	–	–	300	(300)	–	–
Gold	228	–	–	228	–	–	228
Other assets	13,914	(1,438)	–	12,476	(985)	(568)	10,923
Investments in subsidiaries	2,145	–	–	2,145	–	–	2,145
Fixed assets	4,036	(4,036)	–	–	–	–	–
Property, plant and equipment	–	3,994	(3,359)	635	–	–	635
Operating land lease prepayment	–	–	3,145	3,145	–	–	3,145
Intangible assets	–	42	–	42	–	–	42
TOTAL ASSETS	1,061,854	–	(214)	1,061,640	–	(2,424)	1,059,216
LIABILITIES AND EQUITY							
Certificates of Indebtedness	146,775	–	–	146,775	–	(514)	146,261
Government-issued currency notes and coins in circulation	6,351	–	–	6,351	–	(22)	6,329
Balance of the banking system	15,789	–	–	15,789	–	–	15,789
Derivative financial instruments	–	2,372	–	2,372	–	–	2,372
Trading liabilities	–	100	–	100	–	1,491	1,591
Placements by banks and other financial institutions	39,087	–	–	39,087	–	(13)	39,074
Placements by other HKSAR government funds	280,091	–	–	280,091	–	–	280,091
Exchange Fund Bills and Notes issued	125,860	–	–	125,860	–	(2,775)	123,085
Other liabilities	24,310	(2,472)	–	21,838	–	(35)	21,803
Total liabilities	638,263	–	–	638,263	–	(1,868)	636,395
Accumulated surplus	423,397	–	(20)	423,377	–	(556)	422,821
Premises revaluation reserve	194	–	(194)	–	–	–	–
Total equity	423,591	–	(214)	423,377	–	(556)	422,821
TOTAL LIABILITIES AND EQUITY	1,061,854	–	(214)	1,061,640	–	(2,424)	1,059,216

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 period

In respect of the year ended 31 December 2005, it is considered impractical to determine the extent to which the surplus for the year and the net assets would have been higher or lower had the previous accounting policies still been applied.

3.3 Financial instruments (HKAS 39, Financial instruments)

With effect from 1 January 2005, in order to comply with HKAS 32, the Group has provided additional disclosures of terms, conditions, accounting policies, risk and fair values of financial assets and financial liabilities throughout the notes to the financial statements and in the specific notes 35 and 36. In order to comply with HKAS 39, the Group has changed its accounting policies relating to financial assets and financial liabilities to those set out in notes 2.5 to 2.9. In prior years, some financial assets and financial liabilities were carried at cost or amortised cost, net of provisions, while some were held at fair value. With effect from 1 January 2005, and in accordance with HKAS 39, financial assets and financial liabilities are recognised according to the following categories: 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 as set out in note 2.5.2. Further details of the changes are as follows:

(a) Investments in securities

In prior years, investments in securities were classified into:

- other investments in securities, which were carried at fair value with changes in fair value recognised in the income and expenditure account;
- investment securities, which were carried at cost less provision for diminution in value which is other than temporary; and
- held-to-maturity securities, which were carried at amortised cost less provision for diminution in value.

On 1 January 2005, in order to comply with HKAS 39, the first two categories were re-designated into the following categories with the same measurement principles:

- other investments in securities were re-designated as financial assets designated at fair value through profit or loss (note 2.5.2.2); and
- investment in shares of the Bank for International Settlements previously classified as investment securities was re-designated as an available-for-sale security carried at cost (note 2.5.2.5).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(b) Placements with banks and other financial institutions

In prior years, placements with banks and other financial institutions were carried in the balance sheet at fair value. Changes in fair value were recognised in the income and expenditure account.

With effect from 1 January 2005, placements with banks and other financial institutions are carried at amortised cost using the effective interest method, less impairment losses, if any (note 2.5.2.3).

(c) Certificates of Indebtedness and government-issued currency notes and coins in circulation

In prior years, Certificates of Indebtedness and government-issued currency notes and coins in circulation were stated in the financial statements at their Hong Kong dollar face value. At the balance sheet date, the difference between their Hong Kong dollar face value and the market value of the US dollars required for their redemption was included in "other assets" (note 14). With effect from 1 January 2005, in order to comply with HKAS 39, they are stated in the financial statements at amortised cost, which is the Hong Kong dollar equivalent of the US dollars required for their redemption at the exchange rate ruling at the balance sheet date (note 2.5.2.6).

(d) Placements by banks and other financial institutions and other HKSAR government funds

In prior years, placements by banks and other financial institutions and other HKSAR government funds with interest payable based on market rates were valued at fair value. With effect from 1 January 2005, in order to comply with HKAS 39, such fixed maturity placements are carried at amortised cost using the effective interest method, while such placements repayable on demand are stated at the principal amount payable (note 2.5.2.7).

(e) Exchange Fund Bills and Notes

In prior years, long and short positions of EFBN held by the Fund were shown separately from EFBN in issue as assets and liabilities of the Fund. With effect from 1 January 2005, EFBN in issue are derecognised when repurchased by the Fund (note 2.5.4) and short positions taken are categorised as trading liabilities (note 2.5.2.1).

(f) Fair value measurement principles

In prior years, quoted equity securities carried at fair value were priced at closing market prices. Debt securities carried at fair value were priced at mid market prices. With effect from 1 January 2005, financial assets are priced at current bid prices.

In prior years, short positions in debt securities were valued at mid market prices. With effect from 1 January 2005, financial liabilities are priced at current asking prices.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(g) Derivatives and hedge accounting

Derivatives used for investment management

In prior years, transactions undertaken for investment management purposes were marked to market and the revaluation gain or loss was recognised in the income and expenditure account as “net exchange gains/(losses)” for currency derivatives or “other net realised and revaluation gains/(losses)” for other derivatives, and included in the balance sheet as “other assets” or “other liabilities” as appropriate.

Derivatives used for hedging purposes

In prior years, interest rate swaps entered into as a hedge were valued on an equivalent basis to the underlying assets or liabilities which they were hedging. Net interest payable or receivable arising from interest rate swaps was recognised on an accrual basis and charged against interest income or interest expense on the related assets or liabilities.

Any gain or loss on termination of the interest rate swap was deferred and amortised over the remaining original life of the terminated contract. Where the underlying asset or liability was sold or terminated, the hedging interest rate swap was immediately marked to market through the income and expenditure account.

With effect from 1 January 2005, in order to comply with HKAS 39, the Group has changed its accounting policies relating to derivatives and hedge accounting to those set out in notes 2.5.2.1 and 2.8.

(h) Embedded derivatives

In prior years, embedded derivatives were not separately accounted for and they were carried as part of the host contracts.

With effect from 1 January 2005, an embedded derivative that is not closely related to the host contract and where the hybrid (combined) instrument is not measured at fair value through profit or loss is accounted for separately from the host contract (note 2.5.6).

(i) Impairment of financial assets

Loans and advances

In prior years, provisions were made by the HKMC against mortgage loans in accordance with the approved guidelines. General provision related to non-performing exposures not separately identified but known from experience to exist in the mortgage portfolio. Specific provision for bad and doubtful loans generally applied to a mortgage loan that was overdue for more than 90 days, or in case of a mortgage loan which had been rescheduled under the relief plans, where extension of repayment holiday and/or reduction in repayment amount had been granted to the borrower. The specific provision was based on certain percentages of the difference between the current market value or the forced sale value of the underlying property and the outstanding principal balance of the mortgage loan. The percentages were validated annually with reference to the delinquency migration pattern of the mortgage portfolio.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

With effect from 1 January 2005, in order to comply with HKAS 39, the Group has changed its accounting policies relating to impairment on mortgage loans to those set out in note 2.9.

(j) Interest recognition on impaired mortgage loans

In prior years, the accrual of interest on mortgage loans was discontinued when they became overdue for 90 days or more. Interest income on the overdue loans was only recognised when all arrears of principal and interest from the borrowers had been cleared and it was probable that the customer was capable of fully servicing his obligations under the terms of the loans for the foreseeable future.

With effect from 1 January 2005, in order to comply with HKAS 39, the Group has changed its accounting policies and continues to recognise interest income on impaired mortgage loans (note 2.16.1).

(k) Description of transitional provisions and effect of adjustments

The changes in accounting policies of the above items were adopted by way of opening balance adjustments to certain reserves and re-designation of financial instruments as at 1 January 2005 as disclosed in the respective note. Comparative figures have not been restated as this is prohibited by the transitional arrangements in HKAS 39.

The respective adjustments for each financial statement line of the Group and of the Fund affected for the year ended 31 December 2004 and as at 31 December 2004 and 1 January 2005 are set out in notes 3.1.1 and 3.1.2.

3.4 Changes in presentation (HKAS 1, Presentation of financial statements)

(a) Presentation of income and expenditure account and balance sheet

With effect from 1 January 2005, in order to take into account the measurement basis that has been applied, the Group has changed its presentation of certain items on the face of the income and expenditure account and balance sheet. Provisions for bad and doubtful loans are reclassified from "operating expenses" and presented separately as "impairment losses on loans". Fixed assets are split between "property, plant and equipment", "operating land lease prepayment" and "intangible assets". Derivative financial instruments and trading liabilities are reclassified from "other assets" or "other liabilities" and presented separately.

(b) Presentation of share of associate's taxation (HKAS 1, Presentation of financial statements)

In prior years, the Group's share of taxation of associate accounted for using the equity method was included as part of the Group's income tax in the income and expenditure account. With effect from 1 January 2005, in accordance with the implementation guidance in HKAS 1, the Group has changed the presentation and includes the share of taxation of associate in the respective share of profit reported in the consolidated income and expenditure account before arriving at the Group's surplus before taxation.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

- (c) Presentation of minority interests (HKAS 1, Presentation of financial statements and HKAS 27, Consolidated and separate financial statements)

In prior years, minority interests were presented in the consolidated balance sheet separately from liabilities. Minority interests in the results of the Group for the year were also separately presented in the consolidated income and expenditure account as a deduction before arriving at the surplus for the year.

With effect from 1 January 2005, in order to comply with HKAS 1 and HKAS 27, the Group has changed its accounting policy relating to the presentation of minority interests. Under the new policy, minority interests are presented as part of equity, separately from interests attributable to owner of the Fund. Further details of the new policy are set out in note 2.3.

- (d) Intangible assets (HKAS1, Presentation of financial statements and HKAS 38, Intangible assets)

In prior years, computer software licences and capitalised development costs were classified as fixed assets. With effect from 1 January 2005, in order to comply with HKAS 1 and HKAS 38, the Group has changed the presentation and these items are now presented separately as “intangible assets” on the balance sheet.

- (e) Insurance contracts (HKAS 1, Presentation of financial statements and HKFRS 4, Insurance contracts)

In prior years, on consolidation of the HKMC, unearned insurance premium was shown on a net basis in the balance sheet. With effect from 1 January 2005, in order to comply with HKAS 1 and HKFRS 4, the Group has changed the presentation and shows insurance assets and the related insurance liabilities separately and included in “other assets” and “other liabilities” respectively.

These changes in presentation have been applied retrospectively with comparatives reclassified as shown in notes 3.1.1 and 3.1.2.

3.5 Leasehold land and buildings (HKAS 17, Leases and HKAS 16, Property, plant and equipment)

In prior years, leasehold land and buildings held for own use were stated at valuation less accumulated depreciation and accumulated impairment losses. Movements in revaluation surpluses or deficits were taken to the premises revaluation reserve.

With effect from 1 January 2005, in order to comply with HKAS 17, the Group has adopted a new policy for leasehold land and buildings held for own use. Under the new policy, the leasehold interest in the land is accounted for as being held under an operating lease where the fair value of the interest in the building situated on the leasehold land could be measured separately from the fair value of the leasehold land at the time the lease is entered into by the Group (note 2.12).

The building held for own use which is situated on such land leases continues to be presented as part of property, plant and equipment. However, as from 1 January 2005 the building is stated at cost less accumulated depreciation under HKAS 16, rather than at fair value, to be consistent with the new policy required to be adopted for the land element.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

All the above new accounting policies relating to leases have been adopted retrospectively. The adjustments for each financial statement line affected for the year ended 31 December 2004 are set out in note 3.1.1.

4. INCOME AND EXPENDITURE

(a) Investment income

	Group		Fund	
	2005	2004	2005	2004
Interest income				
– from derivative financial instruments	374	684	374	684
– from financial assets designated at fair value through profit or loss	24,782	–	24,782	–
– from other financial assets	6,151	23,914	4,563	22,890
	31,307	24,598	29,719	23,574
Dividend income				
– from financial assets designated at fair value through profit or loss	5,157	–	5,157	–
– from other financial assets	8	4,556	8	4,556
– from subsidiaries	–	–	265	17
	5,165	4,556	5,430	4,573
Net realised and revaluation gains				
– on derivative financial instruments	398	370	1,484	370
– on financial assets and financial liabilities designated at fair value through profit or loss	21,782	–	20,698	–
– on other financial assets and financial liabilities	–	19,750	–	19,750
– on available-for-sale securities	(7)	–	–	–
	22,173	20,120	22,182	20,120
Net exchange gains/(losses)	(19,468)	8,469	(19,474)	8,474
TOTAL INVESTMENT INCOME	39,177	57,743	37,857	56,741

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(b) Interest expense

	Group		Fund	
	2005	2004	2005	2004
Interest expense on Exchange Fund Bills and Notes and other debt securities issued designated at fair value through profit or loss and trading liabilities	3,273	–	3,182	–
Interest expense on other financial liabilities	13,717	18,066	12,844	17,856
TOTAL	16,990	18,066	16,026	17,856
Comprises:				
Interest on placements by other HKSAR government funds				
With interest at rates determined by reference to the investment income of the Fund	10,060	14,533	10,060	14,533
With interest at market-based rates	122	25	122	25
Interest on Exchange Fund Bills and Notes issued	3,061	2,558	3,061	2,558
Other interest expense	3,747	950	2,783	740
	16,990	18,066	16,026	17,856

(c) Operating expenses

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Staff costs				
Salaries and other staff costs	554	523	449	421
Retirement benefit costs	31	31	25	25
Premises and equipment expenses				
Depreciation and amortisation	147	155	116	120
Rental expense under operating leases	5	18	4	10
Other premises expenses	37	39	31	33
General operating costs				
Maintenance of office and computer equipment	33	35	27	30
Financial information and communication services	33	31	28	27
External relations	13	15	12	13
Professional and other services	31	43	23	35
Training	5	5	4	4
Others	3	12	13	10
Investment management and custodian fees	734	547	731	543
TOTAL	1,626	1,454	1,463	1,271

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	
	2005	2004
Fixed pay	47.8	45.9
Variable pay	11.9	7.8
Other benefits	4.4	4.2
	64.1	57.9

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:

HK\$	Group	
	2005	2004
500,000 or below	1	–
1,000,001 to 1,500,000	2	1
2,500,001 to 3,000,000	1	–
3,000,001 to 3,500,000	4	6
3,500,001 to 4,000,000	3	2
4,000,001 to 4,500,000	3	2
5,000,001 to 5,500,000	1	1
5,500,001 to 6,000,000	–	1
6,000,001 to 6,500,000	1	–
8,500,001 to 9,000,000	–	1
9,500,001 to 10,000,000	1	–
	17	14

(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.

(e) Impairment losses on loans/(Provisions made for bad and doubtful loans)

	Group		Fund	
	2005	2004	2005	2004
Write back of impairment losses on loans	19	–	–	–
Provisions made for bad and doubtful loans	–	(89)	–	–
TOTAL	19	(89)	–	–

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 – 2005						
		Financial assets and financial liabilities designated		Trading at fair value	Loans and	Held-to-maturity	Available-for-sale	Other
		Total	instruments	profit or loss	receivables	securities	securities	financial
								liabilities
Notes								
Cash and money at call	6	15,937	-	-	15,937	-	-	-
Placements with banks and other financial institutions	7	75,648	-	-	75,648	-	-	-
Derivative financial instruments	8(a)	1,950	1,950	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9(a)	953,145	-	953,145	-	-	-	-
Available-for-sale securities	10(a)	2,483	-	-	-	-	2,483	-
Held-to-maturity securities	11	4,605	-	-	-	4,605	-	-
Mortgage loans	12	29,476	-	-	29,476	-	-	-
Other assets	14	17,015	-	-	17,015	-	-	-
FINANCIAL ASSETS		1,100,259	1,950	953,145	138,076	4,605	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)	834	834	-	-	-	-	-
Trading liabilities		7,412	7,412	-	-	-	-	-
Placements by banks and other financial institutions	22	25,712	-	-	-	-	-	25,712
Placements by other HKSAR government funds	23	297,086	-	-	-	-	-	297,086
Exchange Fund Bills and Notes issued	24	118,134	-	118,134	-	-	-	-
Other debt securities issued	25	27,991	-	2,600	-	-	-	25,391
Other liabilities	26	24,636	-	-	-	-	-	24,636
FINANCIAL LIABILITIES		658,443	8,246	120,734	-	-	-	529,463

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

		Fund – 2005						
			Financial assets and financial 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(a)	953,145	-	953,145	-	-	-	-
Available-for-sale securities	10(a)	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		7,412	7,412	-	-	-	-	-
Placements by banks and other financial institutions	22	25,712	-	-	-	-	-	25,712
Placements by other HKSAR government funds	23	297,086	-	-	-	-	-	297,086
Exchange Fund Bills and Notes issued	24	118,134	-	118,134	-	-	-	-
Other liabilities	26	18,146	-	-	-	-	-	18,146
FINANCIAL LIABILITIES		623,653	7,937	118,134	-	-	-	497,582

6. CASH AND MONEY AT CALL

	Group		Fund	
	2005	2004	2005	2004
At amortised cost				
Balance with central banks	619	678	619	678
Balance with banks and other financial institutions	15,318	20,081	15,268	20,060
TOTAL	15,937	20,759	15,887	20,738

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

7. PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2005	2004	2005	2004
At amortised cost				
Placements in respect of reverse repurchase agreements				
– with central banks	200	209	200	209
– with banks and other financial institutions	5,488	4,765	5,488	4,765
Other placements with banks and other financial institutions	69,960	43,204	67,432	37,773
TOTAL	75,648	48,178	73,120	42,747

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 35.

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			
	2005 Assets	2005 Liabilities	2004 Assets	2004 Liabilities	2005 Assets	2005 Liabilities	2004 Assets	2004 Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	454	110	1,159	–	421	32	1,159	–
Currency derivatives								
Forward foreign exchange contracts	1,441	411	278	2,341	1,441	410	278	2,341
Others								
Stock index futures contracts	3	82	1	30	3	82	1	30
Bond futures contracts	–	1	–	1	–	1	–	1
	1,898	604	1,438	2,372	1,865	525	1,438	2,372
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	52	229	–	–	–	–	–	–
Currency derivatives								
Currency swap contracts	–	1	–	–	–	–	–	–
	52	230	–	–	–	–	–	–
TOTAL	1,950	834	1,438	2,372	1,865	525	1,438	2,372

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									
	2005					2004				
	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	47,908	9,040	22,903	11,965	4,000	58,269	17,113	13,697	23,459	4,000
Currency derivatives										
Forward foreign exchange contracts	170,673	170,614	59	-	-	152,854	152,854	-	-	-
Others										
Stock index futures contracts	12,736	12,736	-	-	-	12,421	12,421	-	-	-
Bond futures contracts	915	915	-	-	-	989	989	-	-	-
	232,232	193,305	22,962	11,965	4,000	224,533	183,377	13,697	23,459	4,000
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	21,601	1,900	8,423	6,843	4,435	25,000	4,231	3,077	13,599	4,093
Currency derivatives										
Currency swap contracts	83	-	83	-	-	-	-	-	-	-
	21,684	1,900	8,506	6,843	4,435	25,000	4,231	3,077	13,599	4,093
TOTAL	253,916	195,205	31,468	18,808	8,435	249,533	187,608	16,774	37,058	8,093
	Fund Notional amounts with remaining life of									
	2005					2004				
	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	7,900	-	500	3,400	4,000	9,400	500	1,000	3,900	4,000
Currency derivatives										
Forward foreign exchange contracts	170,615	170,614	1	-	-	152,854	152,854	-	-	-
Others										
Stock index futures contracts	12,736	12,736	-	-	-	12,421	12,421	-	-	-
Bond futures contracts	915	915	-	-	-	989	989	-	-	-
TOTAL	192,166	184,265	501	3,400	4,000	175,664	166,764	1,000	3,900	4,000

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

9. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS/ OTHER INVESTMENTS IN SECURITIES

(a) Financial assets designated at fair value through profit or loss

At fair value	Group and Fund	
	2005	2004
Debt securities		
Treasury bills and commercial paper		
Listed outside Hong Kong	1,637	–
Unlisted	170,896	–
Certificates of deposit		
Unlisted	21,908	–
Other debt securities		
Listed		
In Hong Kong	187	–
Outside Hong Kong	284,243	–
Unlisted	256,431	–
Total debt securities	735,302	–
Equity securities		
Listed		
In Hong Kong	87,872	–
Outside Hong Kong	124,230	–
Unlisted	5,741	–
Total equity securities	217,843	–
TOTAL	953,145	–

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(b) Other investments in securities

At fair value	Group and Fund	
	2005	2004
Debt securities		
Treasury bills and commercial paper		
Listed outside Hong Kong	-	3,119
Unlisted	-	271,847
Certificates of deposit		
Unlisted	-	12,637
Other debt securities		
Listed		
In Hong Kong	-	1,518
Outside Hong Kong	-	342,179
Unlisted	-	140,816
Total debt securities	-	772,116
Equity securities		
Listed		
In Hong Kong	-	82,417
Outside Hong Kong	-	123,213
Total equity securities	-	205,630
TOTAL	-	977,746

Following the adoption of HKAS 39 in 2005, "other investments in securities" with a carrying amount of HK\$977,746 million (note 9(b)) and unlisted equity securities with a carrying amount of HK\$985 million previously included in "other assets" (note 14) were re-designated as financial assets at fair value through profit or loss on 1 January 2005. Comparative figures for 2004 were not restated as retrospective application of HKAS 39 is not permitted.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

10. AVAILABLE-FOR-SALE SECURITIES / INVESTMENT SECURITIES

(a) Available-for-sale securities

	Group		Fund	
	2005	2004	2005	2004
Debt securities, at fair value				
Listed in Hong Kong	16	–	–	–
Unlisted	1,563	–	–	–
	1,579	–	–	–
Equity securities				
Listed in Hong Kong, at fair value	411	–	–	–
Unlisted, at cost	493	–	493	–
TOTAL	2,483	–	493	–

(b) Investment securities

	Group		Fund	
	2005	2004	2005	2004
Unlisted equity securities, at cost	–	300	–	300

The Group's investment in unlisted equity securities at 31 December 2005 represents a holding of 4,285 shares (2004: 3,000 shares) in the Bank for International Settlements (also see note 32(a)) with a nominal value of 5,000 Special Drawing Rights each. These shares are 25% paid.

On the adoption of HKAS 39, 3,000 shares with a carrying amount of HK\$300 million, which were previously included in "investment securities", were re-designated as "available-for-sale securities" on 1 January 2005. Comparative figures for 2004 were not restated as retrospective application of HKAS 39 is not permitted. During the year, the Fund subscribed for a further 1,285 shares, which are also 25% paid.

11. HELD-TO-MATURITY SECURITIES

	Group		Fund	
At amortised cost	2005	2004	2005	2004
Debt securities				
Listed				
In Hong Kong	593	224	–	–
Outside Hong Kong	998	1,424	–	–
Unlisted	3,014	2,482	–	–
TOTAL	4,605	4,130	–	–

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

12. MORTGAGE LOANS

	Group		Fund	
	2005	2004	2005	2004
Outstanding principal balance of mortgage loans, at amortised cost	29,529	35,052	-	-
Allowance for loan impairment	(53)	-	-	-
Provisions for bad and doubtful loans	-	(114)	-	-
TOTAL	29,476	34,938	-	-

13. GOLD

	Group and Fund	
	2005	2004
Gold, at market value		
66,798 ounces (2004: 66,798 ounces)	266	228

14. OTHER ASSETS

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Interest and dividends receivable	8,793	8,926	8,475	8,610
Prepayments, receivables and other assets	4,728	633	4,186	35
Unsettled sales and redemption of securities	3,225	2,031	3,225	2,031
Exchange difference on Certificates of Indebtedness, government-issued currency notes and coins in circulation (note 3.3(c))	-	536	-	536
Staff housing loans	263	279	263	279
Tax recoverable	6	-	-	-
Deferred tax assets	-	8	-	-
Unlisted equity securities (note 9)	-	985	-	985
TOTAL	17,015	13,398	16,149	12,476

15. INVESTMENTS IN SUBSIDIARIES

	Fund	
	2005	2004
Unlisted shares, at cost	2,145	2,145

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

The following is a list of the subsidiaries as at 31 December 2005 and 2004:

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, mortgage securitisation and guarantee	HK\$2,000,000,000	100%
Exchange Fund Investment Limited	Hong Kong	Dormant	HK\$5,000,000	100%
Hong Kong Institute for Monetary Research	Hong Kong	Research	HK\$2	100%

All subsidiaries are held directly by the Fund.

The HKMC has unissued authorised share capital of HK\$1 billion (2004: HK\$1 billion), which is callable from the Fund.

16. INVESTMENT IN ASSOCIATE

	Group		Fund	
	2005	2004	2005	2004
Unlisted shares, at cost	–	–	–	–
Share of net assets	26	23	–	–
TOTAL	26	23	–	–

Investment in associate comprises unlisted shares of Hong Kong Interbank Clearing Limited directly held by the Fund at a cost of HK\$5,000 (2004: 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 2004 (restated)	624	522	1,146
Additions (restated)	–	46	46
Disposals	(1)	(15)	(16)
At 31 December 2004 (restated)	623	553	1,176
At 1 January 2005 (restated)	623	553	1,176
Additions	–	65	65
Disposals	(2)	(6)	(8)
At 31 December 2005	621	612	1,233
Accumulated depreciation			
At 1 January 2004 (restated)	5	236	241
Charge for the year (restated)	14	51	65
Written back on disposal	–	(15)	(15)
At 31 December 2004 (restated)	19	272	291
At 1 January 2005 (restated)	19	272	291
Charge for the year	13	47	60
Written back on disposal	–	(6)	(6)
At 31 December 2005	32	313	345
Net book value			
At 31 December 2005	589	299	888
At 31 December 2004 (restated)	604	281	885

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 2004 (restated)	615	163	778
Additions (restated)	–	19	19
Disposals	(1)	(1)	(2)
At 31 December 2004 (restated)	614	181	795
At 1 January 2005 (restated)	614	181	795
Additions	–	21	21
Disposals	(2)	(5)	(7)
At 31 December 2005	612	197	809
Accumulated depreciation			
At 1 January 2004 (restated)	4	127	131
Charge for the year (restated)	14	16	30
Written back on disposal	–	(1)	(1)
At 31 December 2004 (restated)	18	142	160
At 1 January 2005 (restated)	18	142	160
Charge for the year	13	16	29
Written back on disposal	–	(5)	(5)
At 31 December 2005	31	153	184
Net book value			
At 31 December 2005	581	44	625
At 31 December 2004 (restated)	596	39	635

(b) The net book value of premises comprises:

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Held in Hong Kong				
Medium-term leasehold (between 10 and 50 years)	565	580	557	572
Held outside Hong Kong				
Freehold	24	24	24	24
TOTAL	589	604	581	596

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	
	2005	2004 (restated)
Cost		
At 1 January and 31 December	3,231	3,231
Accumulated depreciation		
At 1 January	86	12
Charge for the year	74	74
At 31 December	160	86
Net book value		
At 31 December	3,071	3,145

19. INTANGIBLE ASSETS

	Group and Fund	
	Computer software licences and system development costs	
	2005	2004 (restated)
Cost		
At 1 January	228	222
Additions	4	6
At 31 December	232	228
Accumulated amortisation		
At 1 January	186	170
Charge for the year	13	16
At 31 December	199	186
Net book value		
At 31 December	33	42

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	
	2005	2004	2005	2004
Carrying amount	148,406	146,775	6,671	6,351
Reconciliation with face value:				
Hong Kong dollar face value	HK\$149,295	HK\$146,775 ¹	HK\$6,711	HK\$6,351 ¹
Linked exchange rate for calculating the US dollars required for redemption	US\$1=HK\$7.80		US\$1=HK\$7.80	
US dollars required for redemption	US\$19,140		US\$860	
Market exchange rate for translation into Hong Kong dollars	US\$1=HK\$7.7536		US\$1=HK\$7.7536	
Carrying amount	HK\$148,406		HK\$6,671	

¹ Certificates of Indebtedness and government-issued currency notes and coins in circulation were stated at their Hong Kong dollar face value at 31 December 2004 (note 3.3(c)).

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. PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2005	2004
At amortised cost		
Placements by banks and other financial institutions in respect of securities lending (note 30)	1,001	–
Other placements by banks and other financial institutions	24,711	39,087
TOTAL	25,712	39,087

23. PLACEMENTS BY OTHER HKSAR GOVERNMENT FUNDS

	Group and Fund	
	2005	2004
Placements with interest payable at rates determined by reference to the investment income of the Fund		
General Revenue Account	101,006	90,488
Land Fund	124,334	117,774
Capital Works Reserve Fund	44,273	40,551
Civil Service Pension Reserve Fund	15,294	14,523
Disaster Relief Fund	32	19
Innovation and Technology Fund	4,332	4,292
Lotteries Fund	4,569	4,087
	293,840	271,734
Placements with interest payable at market-based rates		
General Revenue Account	288	481
Capital Investment Fund	852	5,138
Loan Fund	1,295	1,897
Capital Works Reserve Fund	488	564
Innovation and Technology Fund	92	64
Lotteries Fund	231	213
	3,246	8,357
TOTAL	297,086	280,091

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 2005, the interest payable on these placements amounted to HK\$10,068 million (2004: HK\$14,542 million) and is included in “other liabilities” (note 26).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

24. EXCHANGE FUND BILLS AND NOTES ISSUED

At fair value	Group and Fund	
	2005	2004
Exchange Fund Bills and Notes issued		
Exchange Fund Bills	69,384	68,538
Exchange Fund Notes	57,019	57,322
	126,403	125,860
Exchange Fund Bills and Notes held		
Exchange Fund Bills	(7,333)	–
Exchange Fund Notes	(936)	–
	(8,269)	–
TOTAL	118,134	125,860

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.

Following the adoption of HKAS 39 in 2005, all EFBN were designated as at fair value through profit or loss on 1 January 2005. There is no change to the accounting treatment as the EFBN were also carried at fair value with changes in value recorded in the income and expenditure account in prior years.

With effect from 1 January 2005, EFBN held by the Fund as a result of market making activities are considered a redemption of the EFBN issued and are derecognised. At 31 December 2004, EFBN held of HK\$1,315 million were classified as “other investments in securities”.

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

	Group and Fund			
	2005		2004	
Redemption amount	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Exchange Fund Bills and Notes issued by Currency Board Operations segment				
At 1 January	68,579	54,000	68,352	51,800
Issuance	197,261	16,500	190,586	15,400
Redemption	(195,831)	(13,800)	(190,359)	(13,200)
At 31 December	70,009	56,700	68,579	54,000
Long position in Exchange Fund Bills and Notes held by Financial Stability and Other Activities segment at 31 December	(7,359)	(877)	–	–
Total redemption amount	62,650	55,823	68,579	54,000
Carrying amount, at fair value	62,051	56,083	68,538	57,322
Difference	599	(260)	41	(3,322)

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

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

25. OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2005	2004	2005	2004
Debt securities issued, carried at amortised cost				
Notes	3,900	32,495	–	–
Transferable loan certificates	–	3,000	–	–
	3,900	35,495	–	–
Debt securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk				
Notes	21,491	–	–	–
	25,391	35,495	–	–
Debt securities issued, designated at fair value through profit or loss				
Notes	2,600	–	–	–
TOTAL	27,991	35,495	–	–

Following the adoption of HKAS 39 in 2005, debt securities issued with a total carrying amount of HK\$2,995 million, previously carried at amortised cost, were designated as financial liabilities at fair value through profit or loss on 1 January 2005. Comparative figures for 2004 were not restated as retrospective application of HKAS 39 is not permitted.

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

	Group		Fund	
	2005	2004	2005	2004
Total debt securities issued				
Redemption amount at 1 January	35,495	36,620	–	–
Issuance	5,096	11,399	–	–
Redemption	(12,348)	(12,524)	–	–
Redemption amount at 31 December	28,243	35,495	–	–
Carrying amount	27,991	35,495	–	–
Difference	252	–	–	–
Debt securities issued, designated at fair value through profit or loss:				
Redemption amount	2,664	–	–	–
Carrying amount, at fair value	2,600	–	–	–
Difference	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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

26. OTHER LIABILITIES

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Interest payable on placements by other HKSAR government funds				
– at rates determined by reference to the investment income of the Fund	10,060	14,533	10,060	14,533
– at market-based rates	8	9	8	9
	10,068	14,542	10,068	14,542
Other interest payable	828	766	591	538
Unsettled purchases of securities	7,183	6,545	7,183	6,545
Accrued charges and other liabilities	6,495	5,555	304	213
Tax payable	–	54	–	–
Deferred tax liabilities	62	37	–	–
TOTAL	24,636	27,499	18,146	21,838

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

27. EQUITY

	Group		Fund	
	2005	2004 (restated)	2005	2004 (restated)
Accumulated surplus				
At 1 January, as previously reported	425,644	386,441	423,397	384,870
Prior year adjustment in respect of HKAS 16 and 17 (note 3.1.2)	(20)	876	(20)	876
At 1 January, as restated, before opening balance adjustment	425,624	387,317	423,377	385,746
Opening balance adjustment in respect of HKAS 39 (note 3.1.2)	(485)	–	(556)	–
At 1 January, as restated, after opening balance adjustment	425,139	387,317	422,821	385,746
Surplus for the year	20,689	38,307	20,325	37,631
At 31 December	445,828	425,624	443,146	423,377
Premises revaluation reserve				
At 1 January, as previously reported	194	9	194	9
Prior year adjustment in respect of HKAS 16 and 17 (note 3.1.2)	(194)	[9]	(194)	[9]
At 1 January and 31 December, as restated	–	–	–	–
Available-for-sale securities revaluation reserve				
At 1 January	–	–	–	–
Net fair value gains, net of tax	87	–	–	–
Net losses transferred to income and expenditure account on disposal	7	–	–	–
At 31 December	94	–	–	–
Minority interests				
Balance included in equity at 1 January, as previously reported	–	–	–	–
Reclassification (note 3.1.2)	167	160	–	–
At 1 January, as restated	167	160	–	–
Surplus for the year	23	21	–	–
Dividends paid to minority interests	(12)	[14]	–	–
At 31 December	178	167	–	–
TOTAL	446,100	425,791	443,146	423,377

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

28. NOTES TO THE CASH FLOW STATEMENT

Analysis of cash and cash equivalents in the cash flow statement

	Group		Fund	
	2005	2004	2005	2004
Cash and money at call	15,937	20,759	15,887	20,738
Placements with banks and other financial institutions	75,639	48,158	73,120	42,747
Treasury bills and commercial paper	112,776	97,298	112,776	97,298
Certificates of deposit	14,170	12,637	14,170	12,637
TOTAL	218,522	178,852	215,953	173,420

Reconciliation with the balance sheet

	Note	Group		Fund	
		2005	2004	2005	2004
Amounts shown in the balance sheet					
Cash and money at call	6	15,937	20,759	15,887	20,738
Placements with banks and other financial institutions	7	75,648	48,178	73,120	42,747
Financial assets designated at fair value through profit or loss					
– Treasury bills and commercial paper	9(a)	172,533	–	172,533	–
– Certificates of deposit	9(a)	21,908	–	21,908	–
Other investments in securities					
– Treasury bills and commercial paper	9(b)	–	274,966	–	274,966
– Certificates of deposit	9(b)	–	12,637	–	12,637
		286,026	356,540	283,448	351,088
Less: Amounts with original maturity beyond 3 months		(67,504)	(177,688)	(67,495)	(177,668)
Cash and cash equivalents in the cash flow statement		218,522	178,852	215,953	173,420

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

29. SEGMENT REPORTING

The activities of the Fund managed by the HKMA 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 financial and banking system of Hong Kong, including banking supervision, monetary management and the activities of the subsidiaries.

	Currency Board Operations		Reserves Management		Group Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Total	
	2005	2004	2005	2004 (restated)	2005	2004 (restated)	2005	2004 (restated)	2005	2004 (restated)
INCOME	10,842	5,549	26,341	51,003	37,183	56,552	2,431	1,673	39,614	58,225
Expenditure										
Interest expense	3,062	2,559	12,843	15,295	15,905	17,854	1,085	212	16,990	18,066
Other expenses (note 29(b))	-	-	-	-	818	632	997	1,093	1,815	1,725
	3,062	2,559	12,843	15,295	16,723	18,486	2,082	1,305	18,805	19,791
Surplus before share of profit of associate	7,780	2,990	13,498	35,708	20,460	38,066	349	368	20,809	38,434
Share of profit of associate	-	-	-	-	-	-	3	3	3	3
Surplus before taxation	7,780	2,990	13,498	35,708	20,460	38,066	352	371	20,812	38,437
Income tax	-	-	-	-	-	-	(100)	(109)	(100)	(109)
Surplus for the year	7,780	2,990	13,498	35,708	20,460	38,066	252	262	20,712	38,328
Attributable to:										
Owner of the Fund	7,780	2,990	13,498	35,708	20,460	38,066	229	241	20,689	38,307
Minority interests	-	-	-	-	-	-	23	21	23	21
	7,780	2,990	13,498	35,708	20,460	38,066	252	262	20,712	38,328

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 29(c) & (d))		Total		
2005	2004	2005	2004 (restated)	2005	2004 (restated)	2005	2004 (restated)	2005	2004	2005	2004 (restated)	
Assets												
Backing Assets												
Investment in designated US dollar assets	314,228	326,823	-	-	314,228	326,823	-	-	-	-	314,228	326,823
Interest receivable on designated US dollar assets	1,408	453	-	-	1,408	453	-	-	-	-	1,408	453
Net accounts receivable	1,221	-	-	-	1,221	-	-	-	52	-	1,273	-
Other investments	-	-	727,638	713,065	727,638	713,065	47,679	46,414	(7,959)	-	767,358	759,479
Other assets	-	-	14,617	11,427	14,617	11,427	5,510	6,648	149	380	20,276	18,455
TOTAL ASSETS	316,857	327,276	742,255	724,492	1,059,112	1,051,768	53,189	53,062	(7,758)	380	1,104,543	1,105,210
Liabilities												
Monetary Base												
Certificates of Indebtedness	148,406	146,775	-	-	148,406	146,775	-	-	-	-	148,406	146,775
Government-issued currency notes and coins in circulation	6,671	6,351	-	-	6,671	6,351	-	-	-	-	6,671	6,351
Balance of the banking system	1,561	15,789	-	-	1,561	15,789	-	-	-	-	1,561	15,789
Exchange Fund Bills and Notes issued	126,403	125,860	-	-	126,403	125,860	-	-	(8,269)	-	118,134	125,860
Interest payable on Exchange Fund Notes	431	476	-	-	431	476	-	-	-	-	431	476
Net accounts (receivable)/payable	(426)	(380)	-	-	(426)	(380)	-	-	459	380	33	-
Other debt securities issued	-	-	-	-	-	-	27,991	35,495	-	-	27,991	35,495
Placements by banks and other financial institutions	-	-	25,712	39,087	25,712	39,087	-	-	-	-	25,712	39,087
Placements by other HKSAR government funds	-	-	297,086	280,091	297,086	280,091	-	-	-	-	297,086	280,091
Other liabilities	-	-	18,085	23,648	18,085	23,648	14,281	5,847	52	-	32,418	29,495
Total liabilities	283,046	294,871	340,883	342,826	623,929	637,697	42,272	41,342	(7,758)	380	658,443	679,419
Accumulated surplus												
At 1 January	32,405	29,415	381,666	345,431	414,071	374,846	11,553	12,471	-	-	425,624	387,317
Effect of adopting HKAS 39	(44)	-	(513)	-	(557)	-	72	-	-	-	(485)	-
Surplus for the year attributable to owner of the Fund	7,780	2,990	13,498	35,708	20,460	38,066	229	241	-	-	20,689	38,307
Transfer between Currency Board Operations and general reserves (note 29(e))	(6,330)	-	6,721	527	1,209	1,159	(1,209)	(1,159)	-	-	-	-
At 31 December	33,811	32,405	401,372	381,666	435,183	414,071	10,645	11,553	-	-	445,828	425,624
Revaluation reserve	-	-	-	-	-	-	94	-	-	-	94	-
Minority interests	-	-	-	-	-	-	178	167	-	-	178	167
Total equity	33,811	32,405	401,372	381,666	435,183	414,071	10,917	11,720	-	-	446,100	425,791
TOTAL LIABILITIES AND EQUITY	316,857	327,276	742,255	724,492	1,059,112	1,051,768	53,189	53,062	(7,758)	380	1,104,543	1,105,210

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 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's balance sheet.

As at 31 December 2005, deduction from the Backing Assets comprises:

- "other liabilities" of HK\$52 million (2004: Nil) – 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 2005, deductions from the Monetary Base comprise:

- "other assets" of HK\$149 million (2004: HK\$380 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\$2 million (2004: HK\$11 million) and revaluation gains of HK\$147 million (2004: HK\$369 million) on these interest rate swaps are included in "net accounts payable" to reduce the Monetary Base; and
- "other investments" of HK\$310 million (2004: Nil) – 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) Following the adoption of HKAS 39, as at 31 December 2005 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 and general reserve portfolios 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.)

30. PLEDGED ASSETS

Assets are pledged as margin for stock index and bond futures contracts as well as securities lending agreements. Securities lent do not include EFBN in issue. There are no financial assets pledged against contingent liabilities.

	Group and Fund	
	2005	2004
Secured liabilities		
Placements by banks and other financial institutions		
in respect of securities lending (note 22)	1,001	–
Stock index and bond futures contracts – notional amount (note 8(b))	13,651	13,410
Assets pledged		
Financial assets designated at fair value through profit or		
loss, carried at fair value	1,978	1,148

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.

31. COMMITMENTS

(a) Capital commitments

Capital expenditure authorised but not provided for in the financial statements at the balance sheet date was as follows:

	Group		Fund	
	2005	2004	2005	2004
Authorised but not contracted for	62	37	50	17

(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 2005, the HKMA had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$3,768 million equivalent (2004: HK\$4,104 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2005, there was no outstanding balance due from the IMF under this NAB facility (2004: 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 year ended 31 December 2005.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(d) Lease commitments

At 31 December 2005, the total future minimum lease payments under non-cancellable operating leases were payable as follows:

	Group		Fund	
	2005	2004	2005	2004
Premises, leases expiring:				
Not later than one year	3	3	3	3
Later than one year and not later than five years	6	–	6	–
Later than five years	3	–	3	–
TOTAL	12	3	12	3

32. CONTINGENT LIABILITIES

- (a) At 31 December 2005, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$178 million equivalent (2004: 11.25 million Special Drawing Rights or HK\$136 million equivalent), in respect of the uncalled portion of its 4,285 shares (2004: 3,000 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 2005, the total risk-in-force assumed by the HKMC was HK\$2.64 billion (2004: HK\$1.77 billion).
- (c) Under the Guaranteed Mortgage-Backed Pass-Through Securitisation Programme and the Bauhinia Mortgage-Backed Securitisation Programme, the HKMC sells mortgages to two SPEs which issue mortgage-backed securities to investors. The HKMC provides a guarantee on the timely payment of principal and interest in respect of the mortgage-backed securities. At 31 December 2005, the aggregate principal balance guaranteed by the HKMC under the two programmes was HK\$5.20 billion (2004: HK\$5.87 billion).

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

33. MATERIAL RELATED PARTY TRANSACTIONS

Transactions with related parties are conducted at rates determined by the Monetary Authority taking into account the nature of each transaction on a case-by-case basis.

In addition to the transactions and balances disclosed elsewhere in these financial statements, the Group entered into the following material related party transactions.

During the year, the HKMC purchased HK\$174 million (2004: HK\$10 billion) 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.

34. SPECIAL PURPOSE ENTITIES

Effects of the non-consolidation of special purpose entities established by the HKMC

Prior to 1 January 2005, the HKMC established two securitisation programmes (note 32(c)). These securitisations involve transferring mortgages to two SPEs which fund the purchase of these mortgages by issuing mortgage-backed securities (MBS). The HKMC guarantees the payment of principal and interest on the MBS issued by both SPEs. These SPEs are not consolidated in the financial statements as they do not meet the legal definition of a subsidiary set out in the Hong Kong Companies Ordinance.

In prior years, all mortgage loans sold to the SPEs were no longer recognised as an asset in the balance sheet of the Group. Following the adoption of HKAS 39, mortgage loans sold to the SPEs are derecognised only when the rights to receive cash flows from the financial assets have expired or have been transferred and the HKMC has transferred substantially all risks and rewards of ownership. The derecognition requirements do not apply to mortgage loans sold before 1 January 2005 and so the loans previously sold to the SPEs are not included in the Group's balance sheet.

During the year, the HKMC sold HK\$1 billion of mortgage loans to one of the SPEs, Bauhinia MBS Limited, which issued the same amount of MBS guaranteed by the HKMC under the Bauhinia MBS Programme. As this transfer does not meet the new derecognition requirements, the HKMC continues to recognise an asset to the extent of the guarantee given of HK\$1 billion within "mortgage loans". A liability due to Bauhinia MBS Limited of HK\$1 billion in respect of the funding received is also recognised within "other liabilities".

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

If the two SPEs had been consolidated, the Group's assets and liabilities would have increased/decreased as shown in the table below. Surplus for the year of the Group would have increased by HK\$0.04 million (2004: HK\$0.04 million).

	Increase / (decrease) in assets and liabilities	
	2005	2004
At 31 December		
Mortgage portfolio, net	4,076	5,581
Total assets	4,139	5,410
Debt securities	5,164	5,869
Other liabilities	(976)	–
Total liabilities	4,139	5,410

35. RISK MANAGEMENT**35.1 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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

35.2 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.

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

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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

35.3 Risks faced by the Fund**35.3.1 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.

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 23, 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\$293,840 million (2004: HK\$271,734 million) at 31 December 2005.

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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

	Weighted average effective interest rate	Group – 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%	15,416	-	-	-	-	-	15,416	521
Placements with banks and other financial institutions	4.08%	74,452	1,186	10	-	-	-	75,648	-
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	2,242	1,162	-	4,605	-
Mortgage loans	5.48%	29,106	217	81	72	-	-	29,476	-
Interest-bearing assets		252,441	80,950	54,996	283,074	152,899	37,666	862,026	
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		190,456	58,602	39,668	203,950	110,136	27,051	629,863	
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	-
Interest-bearing liabilities		39,345	48,236	39,349	41,026	13,624	915	182,495	
Interest sensitivity gap		151,111	10,366	319	162,924	96,512	26,136	447,368	

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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

		Group – 2004 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	2.26%	20,097	–	–	–	–	–	20,097	662
Placements with banks and other financial institutions	2.23%	44,236	3,923	19	–	–	–	48,178	–
Other investments in securities	2.90%	104,646	144,789	83,116	260,001	140,225	39,339	772,116	205,630
Held-to-maturity securities	3.72%	966	473	737	1,061	893	–	4,130	–
Mortgage loans	1.87%	33,828	727	358	25	–	–	34,938	–
Interest-bearing assets		203,773	149,912	84,230	261,087	141,118	39,339	879,459	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(43,403)	(38,090)	(21,691)	(67,854)	(36,595)	(10,266)	(217,899)	(53,835)
Net interest-bearing assets supporting liabilities bearing interest at market based rates		160,370	111,822	62,539	193,233	104,523	29,073	661,560	
Liabilities									
Trading liabilities	0.06%	100	–	–	–	–	–	100	–
Placements by banks and other financial institutions	0.56%	32,075	7,012	–	–	–	–	39,087	–
Placements by other HKSAR government funds with interest payable at market-based rates	0.44%	4,512	3,845	–	–	–	–	8,357	–
Exchange Fund Bills and Notes issued	0.73%	15,272	36,124	31,217	32,628	10,619	–	125,860	–
Other debt securities issued	3.22%	5,570	6,957	4,614	14,261	3,598	495	35,495	–
Interest-bearing liabilities		57,529	53,938	35,831	46,889	14,217	495	208,899	
Interest sensitivity gap		102,841	57,884	26,708	146,344	90,306	28,578	452,661	

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 sensitivity gap		121,394	12,519	9,009	168,357	98,796	27,051	437,126	

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

		Fund – 2004 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	2.26%	20,085	–	–	–	–	–	20,085	653
Placements with banks and other financial institutions	2.23%	41,581	1,166	–	–	–	–	42,747	–
Other investments in securities	2.90%	104,646	144,789	83,116	260,001	140,225	39,339	772,116	205,630
Interest-bearing assets		166,312	145,955	83,116	260,001	140,225	39,339	834,948	
Less:									
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ¹		(43,403)	(38,090)	(21,691)	(67,854)	(36,595)	(10,266)	(217,899)	(53,835)
Net interest-bearing assets supporting liabilities bearing interest at market based rates		122,909	107,865	61,425	192,147	103,630	29,073	617,049	
Liabilities									
Trading liabilities	0.06%	100	–	–	–	–	–	100	–
Placements by banks and other financial institutions	0.56%	32,075	7,012	–	–	–	–	39,087	–
Placements by other HKSAR government funds with interest payable at market- based rates	0.44%	4,512	3,845	–	–	–	–	8,357	–
Exchange Fund Bills and Notes issued	0.73%	15,272	36,124	31,217	32,628	10,619	–	125,860	–
Interest-bearing liabilities		51,959	46,981	31,217	32,628	10,619	–	173,404	
Interest sensitivity gap		70,950	60,884	30,208	159,519	93,011	29,073	443,645	

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(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, the majority of equity investments are reported as "financial assets designated at fair value through profit or loss" (2004: Other investments in securities) 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.

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 HK\$ equivalents of foreign currency holdings of the Fund:

	Group		2004 (restated)	
	2005 Assets (in HK\$ billion)	2005 Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	128.3	494.3	128.0	517.3
Other US dollar bloc currencies ¹	848.2	162.7	844.9	159.6
	976.5	657.0	972.9	676.9
Non-US dollar bloc	128.0	1.4	132.3	2.5
TOTAL	1,104.5	658.4	1,105.2	679.4

	Fund		2004 (restated)	
	2005 Assets (in HK\$ billion)	2005 Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	95.6	459.8	92.3	476.2
Other US dollar bloc currencies ¹	843.2	162.5	837.0	159.6
	938.8	622.3	929.3	635.8
Non-US dollar bloc	128.0	1.4	132.3	2.5
TOTAL	1,066.8	623.7	1,061.6	638.3

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

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(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.

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.

35.3.2 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 – 2005							Total
	Remaining maturity						Undated or on demand	
	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	-	-	-	-	-	-	15,937	15,937
Placements with banks and other financial institutions	74,452	1,186	10	-	-	-	-	75,648
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	2,243	1,177	-	-	4,605
Mortgage loans	357	336	2,494	12,206	10,272	3,727	84	29,476
	208,276	80,634	57,409	295,628	163,186	41,393	234,768	1,081,294
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
	36,081	46,336	38,980	44,795	13,624	915	452,242	632,973
Liquidity gap	172,195	34,298	18,429	250,833	149,562	40,478	(217,474)	448,321

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

	Group – 2004							Total
	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	–	–	–	–	–	–	20,759	20,759
Placements with banks and other financial institutions	44,236	3,923	19	–	–	–	–	48,178
Other investments in securities	104,646	144,789	83,116	260,001	140,225	39,339	205,630	977,746
Investment securities	–	–	–	–	–	–	300	300
Held-to-maturity securities	962	454	737	1,065	912	–	–	4,130
Mortgage loans	355	500	2,594	12,379	14,593	4,513	4	34,938
	150,199	149,666	86,466	273,445	155,730	43,852	226,693	1,086,051
Liabilities								
Certificates of Indebtedness	–	–	–	–	–	–	146,775	146,775
Government-issued currency notes and coins in circulation	–	–	–	–	–	–	6,351	6,351
Balance of the banking system	–	–	–	–	–	–	15,789	15,789
Trading liabilities	100	–	–	–	–	–	–	100
Placements by banks and other financial institutions	32,075	7,012	–	–	–	–	–	39,087
Placements by other HKSAR government funds	1,671	3,845	–	–	–	–	274,575	280,091
Exchange Fund Bills and Notes issued	15,272	36,124	31,217	32,628	10,619	–	–	125,860
Other debt securities issued	270	4,757	5,041	21,334	3,598	495	–	35,495
	49,388	51,738	36,258	53,962	14,217	495	443,490	649,548
Liquidity gap	100,811	97,928	50,208	219,483	141,513	43,357	(216,797)	436,503

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

	Fund – 2005							Total
	Remaining maturity						Undated or on demand	
	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	-	-	-	-	-	-	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

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

	Fund – 2004							Total
	Remaining maturity						Undated or on demand	
	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	–	–	–	–	–	–	20,738	20,738
Placements with banks and other financial institutions	41,581	1,166	–	–	–	–	–	42,747
Other investments in securities	104,646	144,789	83,116	260,001	140,225	39,339	205,630	977,746
Investment securities	–	–	–	–	–	–	300	300
	146,227	145,955	83,116	260,001	140,225	39,339	226,668	1,041,531
Liabilities								
Certificates of Indebtedness	–	–	–	–	–	–	146,775	146,775
Government-issued currency notes and coins in circulation	–	–	–	–	–	–	6,351	6,351
Balance of the banking system	–	–	–	–	–	–	15,789	15,789
Trading liabilities	100	–	–	–	–	–	–	100
Placements by banks and other financial institutions	32,075	7,012	–	–	–	–	–	39,087
Placements by other HKSAR government funds	1,671	3,845	–	–	–	–	274,575	280,091
Exchange Fund Bills and Notes issued	15,272	36,124	31,217	32,628	10,619	–	–	125,860
	49,118	46,981	31,217	32,628	10,619	–	443,490	614,053
Liquidity gap	97,109	98,974	51,899	227,373	129,606	39,339	(216,822)	427,478

35.3.3 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 mortgage portfolio, which is the risk that a mortgage 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 mortgage 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 2005. The issuer credit exposure represents the carrying amount of the debt securities holdings as indicated in notes 9, 10 and 11.

	Group		Fund	
	2005	2004	2005	2004
Credit rating¹ of the issuers				
AAA	667,086	688,308	666,355	687,210
AA	41,316	55,423	36,334	52,791
A	11,830	10,726	11,369	10,352
BBB+ and below (including un-rated risk)	21,254	21,789	21,244	21,763
	741,486	776,246	735,302	772,116

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 2005, approximately 91% 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 the compliance of the Fund with the established credit policies and procedures.

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

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

(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	
	2005	2004	2005	2004
Financial institutions ¹	91,585	68,937	89,007	63,485
Others ²	29,739	35,217	263	279
	121,324	104,154	89,270	63,764

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

² including mortgage loans and staff housing loans

Counterparty credit risk is diversified as explained in note 35.3.3(a).

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 2005. The issuer credit exposure is the carrying amount of the debt securities as indicated in notes 9, 10 and 11.

	Group		Fund	
	2005	2004	2005	2004
Governments and government agencies ¹	646,677	656,538	646,322	656,275
Supra-nationals	34,654	32,473	34,614	32,456
States, provinces and public-sector entities ²	4,502	36,358	3,615	35,462
Financial institutions	29,188	24,457	25,804	22,500
Others	26,465	26,420	24,947	25,423
	741,486	776,246	735,302	772,116

¹ including debt securities guaranteed by governments

² including debt securities guaranteed by states

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

35.3.4 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.

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.

35.3.5 Operational risk

An internal high-level Risk Committee was established in early 2005. The Committee is chaired by the Chief Executive 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.

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

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 in 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.

36. 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.

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 (2004: HK\$41 million).

All 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 2005 and 2004 except as follows:

	Group			
	Carrying value 2005	2004	Fair value 2005	2004
Financial assets				
Held-to-maturity securities (note 11)	4,605	4,130	4,552	4,194
Financial liabilities				
Other debt securities issued, not designated at fair value through profit or loss (note 25)	25,391	35,495	25,398	36,226

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

37. 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.

38. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE ANNUAL ACCOUNTING PERIOD ENDED 31 DECEMBER 2005

Up to the date of issue of the financial statements, the HKICPA has issued the following amendments, new standards and interpretations which are not yet effective for the accounting period ended 31 December 2005:

	Effective for accounting periods beginning on or after
Not adopted in the financial statements	
HKFRS 6, Exploration for and evaluation of mineral resources	1 January 2006
HK(IFRIC)-Int 4, Determining whether an arrangement contains a lease	1 January 2006
HK(IFRIC)-Int 5, Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds	1 January 2006
HK(IFRIC)-Int 6, Liabilities arising from participating in a specific market-Waste electrical and electronic equipment	1 December 2005
Amendments to HKAS 19, Employee benefits-Actuarial Gains and Losses, Group Plans and Disclosures	1 January 2006
Amendments to HKAS 39, Financial instruments:	
Recognition and measurement:	
– Cash flow hedge accounting of forecast intragroup transactions	1 January 2006
Amendments, as a consequence of the Hong Kong Companies (Amendment) Ordinance 2005, to:	
– HKAS 1, Presentation of financial statements	1 January 2006
– HKAS 27, Consolidated and separate financial statements	1 January 2006
– HKFRS 3, Business combinations	1 January 2006
HKFRS 7, Financial instruments: disclosures	1 January 2007
Amendment to HKAS 1, Presentation of financial statements: Capital disclosures	1 January 2007

Already adopted in the financial statements

Amendments to HKAS 39, Financial instruments:

Recognition and measurement:

- The fair value option 1 January 2006
- Financial guarantee contracts 1 January 2006

The Group is in the process of making an assessment of the impact expected of these amendments, new standards and new interpretations in the period of initial application. So far it has concluded that:

- HKFRS 7 requires more detailed qualitative and quantitative disclosures, primarily in respect of fair values and risk management. The adoption of this standard is therefore only expected to affect the level of detail of the disclosures, and is not expected to have any financial impact nor result in any changes to the Group's accounting policies;

EXCHANGE FUND - NOTES ON THE ACCOUNTS (cont.)

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

- The adoption of HKFRS 6, HK(IFRIC)-Int 5 and HK(IFRIC)-Int 6 and the amendments to HKAS 1 and HKFRS 3 made as a result of the Hong Kong Companies (Amendment) Ordinance 2005 are not applicable to any of the Group's operations;
- The adoption of the amendments to HKAS 27 made as a result of the Hong Kong Companies (Amendment) Ordinance 2005 requires consolidation in the Group's financial statements of a subsidiary, including special purpose entities as described in note 34, that previously did not meet the legal definition of subsidiary. The Group's surplus for the year and its assets and liabilities are expected to be increased as a result of the consolidation of the subsidiaries; and
- The adoption of the other standards and interpretations is unlikely to have a significant impact on the Group's results of operations and financial position.

39. APPROVAL OF ACCOUNTS

The accounts were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 30 March 2006.