

The Exchange Fund

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Report of the Director of Audit



Audit Commission

The Government of the Hong Kong Special Administrative Region

Independent Audit Report

To the Financial Secretary

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

Monetary Authority's responsibility for the financial statements

The Monetary Authority is responsible for the preparation and the true and fair presentation of these financial statements in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance (Cap. 66) and Hong Kong Financial Reporting Standards. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

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

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

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

Report of the Director of Audit

Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Exchange Fund and of the Group as at 31 December 2006 and of their financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance.

Benjamin Tang
Director of Audit

22 March 2007

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

Exchange Fund - Income and Expenditure Account

for the year ended 31 December 2006

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

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

Exchange Fund - Balance Sheet

as at 31 December 2006

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

Joseph Yam

Monetary Authority

22 March 2007

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

Exchange Fund

Exchange Fund - Statement of Changes in Equity

for the year ended 31 December 2006

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

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

Exchange Fund - Cash Flow Statement

for the year ended 31 December 2006

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

Exchange Fund - Cash Flow Statement (cont.)

for the year ended 31 December 2006

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

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

Exchange Fund - Notes on the Accounts

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

1 PRINCIPAL ACTIVITIES

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund (the Fund), manages the Fund in accordance with the provisions of the Exchange Fund Ordinance. The principal activities of the Fund are safeguarding the exchange value of the currency of Hong Kong and maintaining the stability and integrity of Hong Kong's monetary and financial systems. The consolidated financial statements of the Group comprise the Fund and its subsidiaries (together referred to as the "Group") and the Group's interest in an associate. The principal activities of the subsidiaries and the associate are shown in notes 15 and 16.

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

2 SIGNIFICANT ACCOUNTING POLICIES

2.1 Statement of compliance

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

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

2.2 Basis of preparation of the financial statements

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

2.3 Subsidiaries

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

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

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

Minority interests represent the portion of the net assets of subsidiaries attributable to equity interests that are not owned by the Fund, whether directly or indirectly through subsidiaries, and in respect of which the Group has not agreed any additional terms with the holders of those interests which would result in the Group as a whole having a contractual obligation in respect of those interests that meets the definition of a financial liability. Minority interests are presented in the Group balance sheet within equity, separately from equity attributable to the owner of the Fund. Minority interests in the results of the Group are presented on the face of the Group income and expenditure account as an allocation of the surplus for the year between minority interests and the owner of the Fund.

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

Exchange Fund - Notes on the Accounts (cont.)

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

2.4 Associate

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

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

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

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

2.5 Financial assets and financial liabilities

2.5.1 Initial recognition

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

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

2.5.2 Categorisation

2.5.2.1 Trading financial instruments

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

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

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

Financial assets and financial liabilities designated at fair value through profit or loss primarily consist of:

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

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

2.5.2.3 Loans and receivables

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

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

2.5.2.4 Held-to-maturity securities

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

2.5.2.5 Available-for-sale securities

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

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

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

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

2.5.2.6 Other financial liabilities

Other financial liabilities are financial liabilities other than trading liabilities and those designated at fair value through profit or loss.

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

2.5.3 Fair value measurement principles

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

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

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

2.5.4 Derecognition

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

2.5.5 Offsetting

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

2.5.6 Embedded derivatives

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

Embedded derivatives are separated from the host contract and accounted for as a derivative when (a) the economic characteristics and risks of the embedded derivative are not closely related to the host contract; and (b) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the income and expenditure account. Where the embedded derivative is separated, the host contract is accounted for according to its category (note 2.5.2).

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

2.6 Repurchase and reverse repurchase transactions

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

2.7 Securities lending agreements

Where securities are loaned with the receipt of cash or securities as collateral, they are retained on the balance sheet and measured in accordance with their original measurement principles. Where cash collateral is received, a liability is recorded in respect of the cash received in "placements by banks and other financial institutions".

2.8 Hedging

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

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

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

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

2.9 Impairment of financial assets

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

2.10 Gold

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

2.11 Property, plant and equipment

The following items of property, plant and equipment are stated in the balance sheet at cost less accumulated depreciation and any impairment losses (note 2.14):

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

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

2.12 Operating land lease prepayment

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

2.13 Intangible assets

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

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

2.14 Impairment of other assets

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

If any such indication exists, an impairment loss is recognised in the income and expenditure account whenever the carrying amount of an asset exceeds its recoverable amount. The recoverable amount of an asset is the greater of its net selling price and value in use.

2.15 Cash equivalents

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

2.16 Revenue and expenditure recognition

2.16.1 Interest income and expense

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

2.16.2 Net realised and revaluation gains

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

Changes in fair value of trading financial instruments and financial assets and financial liabilities designated at fair value through profit or loss are recognised as revaluation gains or losses in the income and expenditure account.

2.16.3 Dividend and other income

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

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

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

2.16.4 Contributions to staff retirement schemes

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

Exchange Fund - Notes on the Accounts (cont.)

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

2.16.5 Rental payments under operating leases

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

2.16.6 Income tax

The Fund is exempt from income tax. Income tax payable on profits of subsidiaries is recognised as an expense in the period in which profits arise.

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

2.17 Foreign currency translation

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

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

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

2.18 Related parties

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

- (i) the party has the ability, directly or indirectly, to control the Group or exercise significant influence over the Group in making financial and operating policy decisions, or has joint control over the Group;
- (ii) the Group and the party are subject to common control;
- (iii) the party is an associate of the Group;

Exchange Fund - Notes on the Accounts (cont.)

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

- (iv) the party is a member of key management personnel of the Group, or a close family member of such an individual, or is an entity under the control, joint control or significant influence of such individuals;
- (v) the party is a close family member of a party referred to in (i) or is an entity under the control, joint control or significant influence of such individuals; or
- (vi) the party is a post-employment benefit plan which is for the benefit of employees of the Group or of any entity that is a related party of the Group.

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

2.19 Segment reporting

The activities of the Group comprise the following business segments:

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

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

3 CHANGES IN ACCOUNTING POLICIES

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

3.1 Restatement of prior period and opening balances

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

3.1.2 Effect on the Group balance sheet at 31 December 2005

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

3.2.2 Effect on the Group balance sheet at 31 December 2006

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

Exchange Fund - Notes on the Accounts (cont.)

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

4. INCOME AND EXPENDITURE

(a) Investment income

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

Exchange Fund - Notes on the Accounts (cont.)

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

(b) Interest expense

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

Exchange Fund - Notes on the Accounts (cont.)

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

(c) Operating expenses

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

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

HK\$	Group	
	2006	2005
500,000 or below	1	1
1,000,001 to 1,500,000	–	2
2,500,001 to 3,000,000	–	1
3,000,001 to 3,500,000	4	4
3,500,001 to 4,000,000	6	3
4,000,001 to 4,500,000	1	3
5,000,001 to 5,500,000	–	1
5,500,001 to 6,000,000	1	–
6,000,001 to 6,500,000	2	1
9,500,001 to 10,000,000	1	1
	16	17

(d) Note and coin expenses

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

Exchange Fund - Notes on the Accounts (cont.)

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

5 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

6 CASH AND MONEY AT CALL

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

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

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

8 DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments refer to financial contracts whose value depends on the value of one or more underlying assets or indices.

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

Market risk arising from derivative financial instruments is included as part of the Fund's overall market risk exposure. The credit risk arising from these transactions is marked against the Fund's overall credit exposure to individual counterparties. The risk management approaches of the Fund are outlined in note 36.

Exchange Fund - Notes on the Accounts (cont.)

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

(a) Fair values of derivative financial instruments

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

(b) Notional amounts of derivative financial instruments

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

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

Exchange Fund - Notes on the Accounts (cont.)

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

10 AVAILABLE-FOR-SALE SECURITIES

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

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

11 HELD-TO-MATURITY SECURITIES

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

Exchange Fund - Notes on the Accounts (cont.)

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

12 LOAN PORTFOLIO

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

13 GOLD

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

14 OTHER ASSETS

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

Exchange Fund - Notes on the Accounts (cont.)

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

15 INVESTMENTS IN SUBSIDIARIES

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

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

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Note Printing Limited	Hong Kong	Banknote printing	HK\$255,000,000	55%
The Hong Kong Mortgage Corporation Limited	Hong Kong	Investment in mortgages and loans, mortgage securitisation and guarantee	HK\$2,000,000,000	100%

The above subsidiaries are held directly by the Fund.

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

16 INTEREST IN ASSOCIATE

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

17 PROPERTY, PLANT AND EQUIPMENT

(a)

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

(b) The net book value of premises comprises:

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

Exchange Fund - Notes on the Accounts (cont.)

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

18 OPERATING LAND LEASE PREPAYMENT

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

19 INTANGIBLE ASSETS

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

Exchange Fund - Notes on the Accounts (cont.)

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

20 CERTIFICATES OF INDEBTEDNESS, GOVERNMENT-ISSUED CURRENCY NOTES AND COINS IN CIRCULATION

	Group and Fund			
	Certificates of Indebtedness		Government-issued currency notes and coins in circulation	
	2006	2005	2006	2005
Carrying amount	156,926	148,406	6,842	6,671
Reconciliation with face value:				
Hong Kong dollar face value	HK\$157,385	HK\$149,295	HK\$6,862	HK\$6,711
Linked exchange rate for calculating the US dollars required for redemption	US\$1=HK\$7.80	US\$1=HK\$7.80	US\$1=HK\$7.80	US\$1=HK\$7.80
US dollars required for redemption	US\$20,178	US\$19,140	US\$880	US\$860
Market exchange rate for translation into Hong Kong dollars	US\$1=HK\$7.77725	US\$1=HK\$7.7536	US\$1=HK\$7.77725	US\$1=HK\$7.7536
Carrying amount	HK\$156,926	HK\$148,406	HK\$6,842	HK\$6,671

21 BALANCE OF THE BANKING SYSTEM

Under the interbank payment system based on Real Time Gross Settlement principles, all licensed banks maintain a Hong Kong dollar clearing account with the HKMA for the account of the Fund. The aggregate amounts in these clearing accounts, which must not have a negative balance, represents the total level of liquidity in the interbank market.

Under the weak-side Convertibility Undertaking, the HKMA undertakes to convert Hong Kong dollars in these clearing accounts into US dollars at the fixed exchange rate of US\$1=HK\$7.85. Likewise, under the strong-side Convertibility Undertaking, licensed banks can convert US dollars into Hong Kong dollars in these accounts, as the HKMA undertakes to buy US dollars at the fixed rate of US\$1=HK\$7.75. Within the Convertibility Zone bounded by the two Convertibility Undertakings, the HKMA may choose to conduct market operations in a manner consistent with Currency Board principles. Such operations can result in matching changes in the balances of these accounts.

The balance of the banking system is repayable on demand, non-interest bearing and is shown at its Hong Kong dollar amount.

Exchange Fund - Notes on the Accounts (cont.)

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

22 TRADING LIABILITIES

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

23 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

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

Exchange Fund - Notes on the Accounts (cont.)

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

24 PLACEMENTS BY OTHER HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT FUNDS

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

25 EXCHANGE FUND BILLS AND NOTES ISSUED

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

EFBN issued are unsecured obligations of the Fund and are one of the components of the Monetary Base in the Currency Board Account. Exchange Fund Bills are issued by the Fund for maturities not exceeding one year. Exchange Fund Notes are issued by the Fund with 2-year, 3-year, 5-year, 7-year and 10-year maturities. EFBN issued are valued at offer prices derived from Reuters fixings adjusted by observed market spreads.

EFBN held by the Fund as a result of market making activities are considered as redemption of the EFBN issued and are derecognised.

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

26 OTHER DEBT SECURITIES ISSUED

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

27 MORTGAGE-BACKED SECURITIES ISSUED

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

28 OTHER LIABILITIES

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

Exchange Fund - Notes on the Accounts (cont.)

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

29 EQUITY

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

30 NOTES TO THE CASH FLOW STATEMENT

Analysis of cash and cash equivalents in the cash flow statement

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

Exchange Fund - Notes on the Accounts (cont.)

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

Reconciliation with the balance sheet

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

31 SEGMENT REPORTING

The activities of the Group comprise the following business segments:

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Exchange Fund

Exchange Fund - Notes on the Accounts (cont.)

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

	Group											
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Re-allocation (note 31(c) & (d))		Total	
	2006	2005	2006	2005	2006	2005	2006	2005 (restated)	2006	2005	2006	2005 (restated)
Assets												
Backing Assets												
Investment in designated												
US dollar assets	328,567	314,228	-	-	328,567	314,228	-	-	-	-	328,567	314,228
Interest receivable on												
designated US dollar assets	1,963	1,408	-	-	1,963	1,408	-	-	-	-	1,963	1,408
Net accounts receivable	2,143	1,221	-	-	2,143	1,221	-	-	1	52	2,144	1,273
Other investments	-	-	821,411	727,638	821,411	727,638	47,473	51,751	(2,244)	(7,959)	866,640	771,430
Other assets	-	-	14,422	14,617	14,422	14,617	5,570	5,521	189	149	20,181	20,287
TOTAL ASSETS	332,673	316,857	835,833	742,255	1,168,506	1,059,112	53,043	57,272	(2,054)	(7,758)	1,219,495	1,108,626
Liabilities												
Monetary Base												
Certificates of Indebtedness	156,926	148,406	-	-	156,926	148,406	-	-	-	-	156,926	148,406
Government-issued currency												
notes and coins												
in circulation	6,842	6,671	-	-	6,842	6,671	-	-	-	-	6,842	6,671
Balance of the banking												
system	2,035	1,561	-	-	2,035	1,561	-	-	-	-	2,035	1,561
Exchange Fund Bills and												
Notes issued	132,113	126,403	-	-	132,113	126,403	-	-	(2,974)	(8,269)	129,139	118,134
Interest payable on Exchange												
Fund Notes	467	431	-	-	467	431	-	-	-	-	467	431
Net accounts (receivable)/												
payable	(911)	(426)	-	-	(911)	(426)	-	-	919	459	8	33
Other debt securities issued	-	-	-	-	-	-	28,910	27,991	-	-	28,910	27,991
Mortgage-backed securities												
issued	-	-	-	-	-	-	5,341	5,145	-	-	5,341	5,145
Placements by banks and												
other financial institutions	-	-	7,572	25,712	7,572	25,712	-	-	-	-	7,572	25,712
Placements by other HKSAR												
government funds	-	-	324,530	297,086	324,530	297,086	-	-	-	-	324,530	297,086
Placements by Hong Kong												
statutory bodies	-	-	-	-	-	-	26	-	-	-	26	-
Other liabilities	-	-	38,979	18,085	38,979	18,085	7,607	13,221	1	52	46,587	31,358
Total liabilities	297,472	283,046	371,081	340,883	668,553	623,929	41,884	46,357	(2,054)	(7,758)	708,383	662,528
Accumulated surplus												
At 1 January	33,811	32,361	401,372	381,153	435,183	413,514	10,643	11,622	-	-	445,826	425,136
Surplus for the year attributable												
to owner of the Fund	8,526	7,780	57,258	13,498	64,666	20,460	321	230	-	-	64,987	20,690
Transfer between Currency												
Board Operations and general												
reserves (note 31(e))	(7,136)	(6,330)	6,122	6,721	104	1,209	(104)	(1,209)	-	-	-	-
At 31 December	35,201	33,811	464,752	401,372	499,953	435,183	10,860	10,643	-	-	510,813	445,826
Revaluation reserve	-	-	-	-	-	-	125	94	-	-	125	94
Minority interests	-	-	-	-	-	-	174	178	-	-	174	178
Total equity	35,201	33,811	464,752	401,372	499,953	435,183	11,159	10,915	-	-	511,112	446,098
TOTAL LIABILITIES AND EQUITY	332,673	316,857	835,833	742,255	1,168,506	1,059,112	53,043	57,272	(2,054)	(7,758)	1,219,495	1,108,626

Exchange Fund - Notes on the Accounts (cont.)

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

(a) Currency Board Operations

Starting from 1 October 1998, specific US dollar assets of the Fund have been designated to back the Monetary Base, which comprises Certificates of Indebtedness, government-issued currency notes and coins in circulation, the balance of the banking system and EFBN. While specific assets of the Fund have been earmarked for backing the Monetary Base, all the Fund's assets have continued to be available for the purpose of supporting the Hong Kong dollar exchange rate under the Linked Exchange Rate system.

(b) Other expenses

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

(c) Re-allocation of assets and liabilities

For the purpose of the Currency Board Operations segment, certain liabilities of the Fund are deducted from the Backing Assets and certain assets are deducted from the Monetary Base in order to allow proper computation of the Backing Ratio. This re-allocation adjustment adds back these items in order to reconcile the segmental information to the Group balance sheet.

As at 31 December 2006, deduction from the Backing Assets comprises:

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

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

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

(d) EFBN held by the Financial Stability and Other Activities segment are treated as redemption of EFBN issued in the Currency Board Operations segment.

(e) In accordance with an arrangement approved by the Financial Secretary in January 2000, assets can be transferred between the backing portfolio and general reserves when the Backing Ratio reaches either the upper trigger point (112.5%) or the lower trigger point (105%). This arrangement allows transfer of excess assets out of the backing portfolio to maximise their earning potential while ensuring that there are sufficient liquid assets in the backing portfolio.

Exchange Fund - Notes on the Accounts (cont.)

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

32 PLEDGED ASSETS

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

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

During the year, the Group entered into collateralised reverse repurchase agreements, repurchase agreements and securities lending transactions that may result in credit exposure in the event that the counterparty to the transaction is unable to fulfil its contractual obligations. The Group controls credit risk associated with these activities by monitoring counterparty credit exposure and collateral values on a daily basis and requiring additional collateral to be deposited with or returned to the Group when deemed necessary.

33 COMMITMENTS

(a) Capital commitments

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

	Group		Fund	
	2006	2005	2006	2005
Authorised but not contracted for	39	62	27	50

Exchange Fund - Notes on the Accounts (cont.)

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

(b) Credit facility to the International Monetary Fund

On 27 January 1997, the HKMA participated in the New Arrangements to Borrow (NAB), a standby credit facility provided to the International Monetary Fund (IMF) for the purpose of managing instability in the international monetary system. At 31 December 2006, the HKMA had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$3,978 million equivalent (2005: HK\$3,768 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2006, there was no outstanding balance due from the IMF under this NAB facility (2005: Nil).

(c) Repurchase agreements with other central banks

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

(d) Lease commitments

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

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

34 CONTINGENT LIABILITIES

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

Exchange Fund - Notes on the Accounts (cont.)

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

35 MATERIAL RELATED PARTY TRANSACTIONS

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

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

During the year, the HKMC purchased HK\$107 million (2005: HK\$174 million) of mortgage loans from the HKSAR Government.

The Exchange Fund Advisory Committee (EFAC) through its Sub-Committees advises the Financial Secretary in his control of the Exchange Fund. Members of EFAC and its Sub-Committees are appointed in a personal capacity by the Financial Secretary for the expertise and experience that they can bring to the Committees. It is not appropriate to disclose details of transactions with companies related to Committee members as all such transactions have been conducted as a normal part of the operation of the Fund and on terms consistent with its ongoing operations.

36 RISK MANAGEMENT

36.1 Governance

The Financial Secretary is advised by EFAC in his control of the Exchange Fund. EFAC is established under Section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Exchange Fund. Members of EFAC are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the HKSAR for the expertise and experience that they can bring to the Committee. Such expertise and experience includes knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC.

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

36.2 Investment management and control

Investment activities of the Fund are conducted in accordance with the investment benchmark derived from the Fund's investment objectives. The investment benchmark directs the long-term strategic asset allocation of the Fund and is reviewed on a regular basis to ensure that it consistently meets the investment objectives. Changes to the investment benchmark, if required, must be endorsed by EFAC.

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

In addition to the investment benchmark, EFAC determines the tactical deviation limits governing the extent to which the Fund's asset and currency allocations may deviate from the investment benchmark. The tactical deviation limits are used to guide the medium term investments for the Fund. The tactical deviation limits are derived from a risk-based approach, taking into account the risk tolerance level set by EFAC and risk contributions of the asset classes and markets that the Fund is allowed to invest in. These risk contributions reflect the neutral allocations of asset markets within the investment benchmark, and the volatility of and correlation across asset markets. Authority to take medium term investment decisions is delegated to senior management of the HKMA down to the Executive Director level.

36.3 Risks faced by the Fund

36.3.1 Market risk

Market risk is the risk that changes in market variables such as interest rates, equity prices and exchange rates may affect the fair value or cash flows of a financial instrument.

(a) Interest rate risk

Interest rate risk refers to the risk of loss arising from changes in market interest rates. This can be further classified into fair value interest rate risk and cash flow interest rate risk.

Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates. The Fund is exposed to fair value interest rate risk since a substantial portion of its investments is in fixed rate debt securities. These securities are subject to interest rate risk as their values will fall when market interest rates increase. Other significant financial assets and financial liabilities with a fixed interest rate and therefore subject to interest rate risk include placements with banks and other financial institutions, and EFBN issued.

Exchange Fund - Notes on the Accounts (cont.)

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

Cash flow interest rate risk is the risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Because the Fund has no significant floating rate investments and liabilities, the Fund's future cash flows are not materially affected by potential changes in market interest rates.

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

(b) Equity price risk

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

(c) Currency risk

Currency risk is the risk of loss arising from changes in foreign exchange rates. A large portion of foreign currency assets is held in US dollars with the remaining in other major international currencies. When the exchange rates of the relevant foreign currencies against the Hong Kong dollar fluctuate, the value of these foreign currency assets expressed in Hong Kong dollar will vary accordingly.

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

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

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

(d) Monitoring market risks

The investment benchmark and tactical deviation limits of the Fund govern the asset allocation strategies. This, together with the volatility of asset markets, will affect the Fund's market risk exposure. As explained in note 8, the Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies for the Fund. The market risk of the Fund is measured and monitored using the Value-at-Risk (VaR) methodology.

Exchange Fund - Notes on the Accounts (cont.)

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

VaR is calculated using the parametric approach based on a 95% confidence level and one-month time horizon. The result represents the maximum expected loss of the Fund over a one-month period under normal market conditions, with a 5% chance that the actual loss may exceed the calculated VaR. The Fund's absolute VaR and the relative VaR (i.e. the VaR of the Fund relative to its investment benchmark), expressed in both dollar amounts and percentage terms, are measured and reported on a regular basis. The relative VaR of the Fund in percentage terms is also used to measure the actual tracking error of the Fund against its investment benchmark. This is regularly monitored against the tracking error limit endorsed by EFAC to ensure that the market risk exposure of the Fund is within its limits.

VaR is a widely accepted measure of market risk within the financial services industry. It provides users with a single amount to measure market risk and takes into account multiple risks. VaR should however be assessed in the context of some of its inherent limitations. The calculation of VaR involves a number of assumptions that may or may not be valid in a real life scenario, in particular in extreme market conditions. The calculation of VaR assumes that future events can be predicted by historical data, and that changes in risk factors follow a normal distribution. In addition, the confidence level on which calculation of VaR is based needs to be taken into account as it indicates the possibility that a larger loss could be realised.

To compensate for some of the limitations of VaR, the HKMA also conducts stress tests to estimate the potential losses under extremely adverse market conditions. This serves to identify the major attributes of market risk under extreme market conditions, and helps to prevent the Fund from being exposed to excessive market risk. The results of the stress tests are also reported to EFAC on a regular basis.

36.3.2 Liquidity risk

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

36.3.3 Credit risk

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

Counterparty credit exposures arise mainly from the Group's lending activities, deposit placements with financial institutions, derivatives transactions and repurchase and reverse repurchase agreements. Since the Fund will conduct transactions with a counterparty for a range of financial instruments, credit limits are established to control the overall exposure to each authorised counterparty based on its credit ratings, financial strength and the size of its total assets and capital. Counterparty credit exposures are measured according to the risk nature of financial products involved in the transaction.

Exchange Fund - Notes on the Accounts (cont.)

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

(a) Maximum exposure to counterparty risk

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

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

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

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

To maintain the asset quality of the loan and mortgage insurance portfolios, the HKMC adheres to a four-pronged approach to (i) selecting Approved Sellers carefully, (ii) adopting prudent mortgage purchasing criteria and insurance eligibility criteria, (iii) conducting effective due diligence reviews and (iv) ensuring adequate protection for higher-risk mortgages or transactions. The HKMC has no significant concentration of credit risk. Risk exposure is spread over a large number of customers, counterparties and a diversified distribution of underlying collateral in Hong Kong.

(b) Maximum exposure to issuer risk

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

Issuer risk arises from investments in debt securities. Credit limits to approved issuers are set on an individual and group level to control the risk of loss caused by the default of debt securities issuers and to prevent undue risk concentration.

Moreover, to qualify as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Fund. The Fund predominantly invests in liquid Organisation for Economic Co-operation and Development (OECD) government bonds and other quasi-government debt securities issues. As at 31 December 2006, approximately 91% (2005: 90%) of the debt securities held by the Fund were rated "triple-A" by Moody's or Standard and Poor's.

In addition to the counterparty and issuer risk, the Fund is exposed to country risk, which is broadly defined to include both the transfer risk and the sovereign risk. Under the existing framework, country limits are established to control the Fund's overall credit risk exposures to the countries endorsed by EFAC. These country limits are set to reflect the status of a country's sovereign credit quality and the risks of default of the debt issued by its government.

Credit exposure is monitored against the established limits on a daily basis. To ensure prompt identification, proper approval and consistent monitoring of credit risk, the Fund has implemented a unified automated credit monitoring system which provides fully-integrated straight-through-processing linking the front, middle and back office functions. The pre-deal checking takes place in the front office prior to the commitment of any transaction to ensure that the intended transaction will not exceed the credit limits. The end-of-day compliance checking further verifies that the Fund complies with the established credit policies and procedures.

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

(c) Concentration of credit risk

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

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

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

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

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

¹ including debt securities guaranteed by governments

² including debt securities guaranteed by states

36.3.4 Mortgage insurance risk

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

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal risk that the HKMC faces under its insurance contracts is that the actual claims exceed the carrying amount of the insurance liabilities. This could occur because the frequency or severity of claims are greater than estimated. The actual number and amount of claims and benefits will vary year to year from the estimate established using statistical techniques.

Experience shows that the larger the portfolio of similar insurance contracts, the smaller the relative variability about the expected outcome will be. In addition, a more diversified portfolio is less likely to be affected across the board by a change in any subset of the portfolio. The HKMC has developed a business strategy to diversify the type of mortgage insurance risks accepted and within each of the key categories to achieve a sufficiently large population of risks to reduce the variability of the expected outcome.

Exchange Fund - Notes on the Accounts (cont.)

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

The frequency and severity of claims can be affected by several factors which cause collateral values fall below the outstanding balance of the mortgage loans. The most significant are a downturn in the economy and a decline in local property values. Economic downturn, which may cause a rise in defaults, affects the frequency of claims.

The HKMC manages these risks by adopting a set of prudent insurance eligibility criteria. To ensure sufficient provision is set aside for meeting future claim payments, the HKMC calculates technical reserves on prudent liability valuation assumptions and the methods prescribed in the regulatory guidelines. The HKMC also takes out quota-share reinsurance from its approved mortgage reinsurers in an effort to limit its risk exposure. The reinsurers are selected according to prudent criteria and their credit ratings are reviewed regularly.

36.3.5 Operational risk

An internal high-level Risk Committee was established in early 2005. The Committee is chaired by the Chief Executive of the HKMA and the three Deputy Chief Executives serve as members. The Risk Committee provides direction and assistance for senior management in managing risk in the HKMA's operations.

The HKMA has put in place a formal risk assessment process. This is conducted on an annual basis and requires each division to assess and rank the potential impact and likelihood of occurrence of financial and operational risks that may affect the HKMA and the Fund. It also requires the relevant divisions to review the procedures and measures in place to address the identified risks. The assessment and ranking is then reviewed by Internal Audit for consistency and reasonableness before being submitted to the Risk Committee, which has the responsibility for ensuring that the identified risks are properly addressed. This risk assessment is then used as the basis for the annual Internal Audit plan. Internal Audit will audit the risk areas at various frequencies depending on the levels of risks assigned to the areas.

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

37 FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. In the absence of such quoted market prices, fair values are estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date, and assuming no change in credit spread where there is no objective evidence of impairment.

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

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

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

38 NON-ADJUSTING POST BALANCE SHEET EVENT

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

39 COMPARATIVE FIGURES

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

Exchange Fund - Notes on the Accounts (cont.)

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

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

Up to the date of issue of the financial statements, the HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2006 and which have not been early adopted in the financial statements.

The Group is in the process of making an assessment of what the impact of these amendments, new standards and interpretations is expected to be in the period of initial adoption. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's results of operations and financial position.

The following developments may result in new or amended disclosures in future financial statements:

	Effective for accounting periods beginning on or after
HKFRS 7, <i>Financial instruments: disclosures</i>	1 January 2007
Amendment to HKAS 1, <i>Presentation of financial statements: capital disclosures</i>	1 January 2007

41 APPROVAL OF ACCOUNTS

The accounts were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 22 March 2007.