



HONG KONG MONETARY AUTHORITY
香港金融管理局

Annual Report 2007

Hong Kong Monetary Authority

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

The HKMA's policy objectives are

- to maintain currency stability within the framework of the Linked Exchange Rate system
- to manage the Exchange Fund
- to promote the safety and stability of the banking system
- to maintain and develop Hong Kong's financial infrastructure.

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

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

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

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The chapter on Banking Stability in this Annual Report is the report on the working of the Banking Ordinance and the activities of the office of the Monetary Authority during 2007 submitted by the Monetary Authority to the Financial Secretary in accordance with Section 9 of the Banking Ordinance.

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

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

A summary version of this Report is also available in *An Introduction to the Hong Kong Monetary Authority 2008 Edition*.

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

Highlights of 2007

Economic and Banking Environment

Hong Kong's economy remains strong in 2007, registering above-trend growth for the fourth consecutive year. Real GDP grows by 6.3%.

The banking sector remains sound, with stable macroeconomic conditions underpinning profitability and keeping credit losses low.

Monetary Stability

Monetary conditions remain stable and Hong Kong's foreign-exchange and money markets are orderly despite increased volatility during the year.

The HKMA's market operations in October 2007 help maintain the stability of the Hong Kong dollar and demonstrate the resilience of the Linked Exchange Rate system.

Banking Stability

Authorized institutions continue to be well capitalised under the capital reporting framework of Basel II.

The HKMA strengthens its supervisory work and monitoring of the impact of the US sub-prime problem on Hong Kong's banking sector.

A review of the HKMA's work on banking stability has begun.

Market Infrastructure

The renminbi RTGS system is launched.

Hong Kong's US-dollar RTGS system and Malaysia's debt securities settlement system are linked.

The first 15-year Exchange Fund Notes are issued.

International Financial Centre

Significant progress is achieved in the implementation of the recommendations of the Action Agenda of "China's 11th Five-Year Plan and the Development of Hong Kong".

The credit ratings given to Hong Kong by all major international credit rating agencies are at an all-time high of "AA".

Reserves Management

The Exchange Fund achieves an investment income of \$142.2 billion in 2007 and a return of 11.8%, exceeding the benchmark investment return by more than 1.2%.

Total assets of the Exchange Fund reach \$1,414.4 billion at the end of 2007.

Chief Executive's Statement



Developments in 2007 kept the HKMA very busy: the further weakening of the US dollar and appreciation of the renminbi; the various measures by the Mainland authorities to cool the economy; continued strong economic growth at home; record activity in the Hong Kong stock market, resulting in significant inflows of funds and some upward pressure on the Hong Kong dollar; the sub-prime crisis and the resulting international liquidity and credit crunch in the second half of the year – all of these helped make 2007 an interesting and challenging year for us. Volatility is a favourite word in central-banking circles, and we heard it often last year. And yet, against this difficult background, the Exchange Fund achieved a record investment return for the people of Hong Kong, the Hong Kong dollar and

the local banking sector remained stable despite the market turbulence, we continued to strengthen Hong Kong's financial infrastructure and made further progress in developing and maintaining Hong Kong as an international financial centre.

Continuing economic growth

The local economy continued its above-trend growth, expanding by 6.3% in 2007, compared with 7.0% in 2006. Monetary conditions eased further as the US Federal Reserve began a series of interest-rate reductions in September, partly in response to the sub-prime problems that emerged in August. The unemployment rate continued to decline, reaching 3.4% in December, its lowest level for nearly 10 years. Although the average inflation rate in Hong Kong for the year measured by the Composite Consumer Price Index remained low at 2% (the figure was 3.8% at the end of 2007), underlying inflation picked up to 2.8%. The main factors in this increase were strong domestic demand; increases in the prices of retained imports, especially food; a tightening labour market; and the weakness of the US dollar. We will need to be alert for any increase in the rate of inflation in the coming year.

The stock market had a very strong year with the Hang Seng Index closing at a record high of 31,638 points on 30 October before falling back towards the end of the year. But volatility also increased significantly and the turmoil in global markets clearly affected sentiment. Average daily turnover for the year was \$87 billion with a peak of \$210 billion on 3 October.

The Exchange Fund

The Exchange Fund achieved a record investment income of \$142.2 billion, a rate of return of 11.8%. It also outperformed the benchmark set by the Financial Secretary on the advice of the Exchange Fund Advisory Committee by 126 basis points. This was a very pleasing result, particularly since it was achieved in a year when there was more volatility and turbulence in global financial markets than we have seen for some time. And of course that volatility and turbulence have continued into 2008, making the investment environment for this year uncertain at best.

In these circumstances, it would be well to remember that the Exchange Fund is not primarily an investment fund: its primary purpose, set out in the Exchange Fund Ordinance, is to support the Hong Kong dollar. While it is obviously important to make the best return we can, it is even more important to maintain monetary stability for the benefit of the economic well-being of Hong Kong and its people.

Hong Kong dollar stability

And 2007 was also an eventful year in the area of monetary stability. In January, the renminbi appreciated past the Hong Kong-dollar spot exchange rate with the US dollar, passing through the Hong Kong-dollar Convertibility Zone by mid-February. This was, at least potentially, a psychologically sensitive event, and there was some market speculation that the Hong Kong dollar would be allowed to rise in the wake of the renminbi. To address this potentially de-stabilising sentiment, the HKMA re-doubled its efforts to communicate with the markets and the general community to stress that there was no intention of abandoning the Linked Exchange Rate system, which has served Hong Kong well through a number of financial storms in the last 24 years, and continues to be the best guarantee of stability. In the event, the appreciation of the renminbi past the Hong Kong dollar / US dollar exchange rate passed without much reaction in the markets, suggesting that our view of the importance of monetary stability is widely shared.

In the first seven months of the year, the Hong Kong dollar weakened as domestic interest rates were below their US counterparts, and newly listed companies switched the proceeds of their IPOs out of the local currency. But from August to October, the exchange rate strengthened as the sub-prime crisis led to global risk aversion and the unwinding of Hong Kong-dollar-funded carry trades, demand for the local currency increased because of a series of large IPOs in the stock market, and a pilot scheme to allow individual Mainland investors to buy Hong Kong equities was announced. Short-term interest rates were firm and an up-coming IPO was expected to tighten the money market further. On 23 October, after the Hong Kong dollar had strengthened close to (and at one point touched) the strong-side Convertibility Undertaking, the HKMA operated within the Convertibility Zone to sell Hong Kong dollars against US dollars. Then the strong-side Convertibility Undertaking was triggered passively once on 26 October and five times on 31 October, with the HKMA selling Hong Kong dollars in accordance with the automatic mechanism of the Currency Board.

Following these market operations, the exchange rate and local interbank interest rates softened. In November and December the exchange rate moved back towards the centre of the Convertibility Zone and the Aggregate Balance stood at \$10.6 billion at the end of the year, having been steady at \$1.3 billion for more than two years. Earlier this year, the balance was reduced to \$4.6 billion through a tap issue of \$6 billion of three-month Exchange Fund Bills. This issue was well received by the market since it helped meet the increased demand for Exchange Fund paper for intra-day liquidity management.

Despite all the volatility, the very large fund flows, the external shocks and market speculation, monetary conditions remained stable during the year. I believe this underlines both the robustness of the Linked Exchange Rate system and its importance in protecting us from the turbulence in the global financial systems that is inevitable from time to time.

The banking sector

On 1 January, after long and intensive preparation, the new capital-adequacy framework for banks, known as Basel II, was implemented in Hong Kong, making us one of the first jurisdictions in the world to introduce the new system. This marks the fruition of several years' work for us and for the authorized institutions. But the work is far from over, and we are continuing to work with individual institutions, and the sector as a whole, on implementing the new system.

The banking sector remained very strong in 2007: aggregate pre-tax operating profits of retail banks' Hong Kong offices rose by 31.1%; the net interest margin widened to 1.87% from 1.80% in 2006; the retail banks saw improvements in income from fees, commissions and trading investment; and bad debt charges, although increasing in absolute terms compared with 2006, amounted to only 0.04% of average total assets, a record low. Lending grew strongly across the board as activity in the stock and property markets increased, and economic growth stimulated the trade and manufacturing sectors. Customer deposits also expanded and the banks remained highly liquid, with aggregate loan-to-deposit ratios of 65.1% in Hong Kong dollars and 45.5% in all currencies. The sector also remained very well capitalised, with the average consolidated capital-adequacy ratio of locally incorporated authorized institutions standing at 13.4% at the end of the year, calculated on the new Basel II basis.

Of course, the Hong Kong banking sector could not escape entirely the effects of the sub-prime crisis that began in the US in August, and some local institutions saw their profits adversely affected by exposure to sub-prime assets. Fortunately, the strong financial and liquidity positions of the sector as a whole provide a substantial cushion against any further problems in the global system, and I am sure the banks will exercise their customary prudence. But the world is an uncertain place, and in 2008 banks will need to pay particular attention to liquidity management and the risks arising from increased market volatility.

Hong Kong as an international financial centre

Towards the end of the year, we appointed a consultant to review how the HKMA can best fulfil its responsibilities in the area of ensuring banking stability. The local banking sector is healthy and, we believe, well regulated. But it does not pay to be complacent in a rapidly changing world, and we believe that an objective, outside view will help us to identify current and future challenges. The consultant will make his recommendations later this year, after consulting widely with the industry and the community.

The volatility in financial markets in 2007 underlines the need to keep a careful watch for risks to stability globally and in the region, including Hong Kong. We therefore stepped up our efforts, in co-operation with other central banks and regional and international bodies, to monitor and study economic and market developments that could affect financial stability.

We were particularly pleased to see a series of upgrades of Hong Kong's sovereign credit ratings during the year. At the end of the year Hong Kong enjoyed AA ratings, its highest ever. This may seem an obscure subject to many people, but better sovereign ratings lower the costs of funding for local debt issuers and help to increase market confidence in the Linked Exchange Rate system and monetary stability, which in turn helps to underpin economic growth. The HKMA was heavily involved during the year, with the Government, in making the case to the international credit rating agencies that Hong Kong's strong economic fundamentals and fiscal position merit higher ratings. We firmly believe that Hong Kong belongs among the world's triple-A economies and we will continue to argue for improvements to our ratings.

Probably the biggest factor in Hong Kong's status as an international financial centre is, of course, the increasing integration of our economy and financial systems with those of the Mainland. The HKMA played an important role in helping to draw up the Action Agenda on "China's 11th Five Year Plan and the Development of Hong Kong" released in January, and we continued to contribute to its implementation throughout the year. As a result, new measures were included in Supplement IV to CEPA to make it easier for Hong Kong banks to establish and expand their presence on the Mainland; expanded Qualified Domestic Institutional Investors schemes were introduced in August; and the State Administration of Foreign Exchange announced a pilot scheme for Mainland residents to invest in overseas markets. These developments will all contribute to making Hong Kong a platform for the orderly outflow of funds from the Mainland and help to develop the market.

A milestone in the development of renminbi business in Hong Kong was reached in July with the first issue of renminbi-denominated bonds by a Mainland institution in Hong Kong, the first time renminbi bonds have been issued anywhere outside the Mainland. By the end of the year, there had been three issues totalling RMB10 billion providing a new investment instrument for banks and depositors and a new source of funding for Mainland issuers.

A safe and efficient financial infrastructure

We also increased our efforts in studying economic developments on the Mainland and their significance for Hong Kong during the year. Many of the studies we have carried out, and our other extensive research, can be viewed on the HKMA website and I hope they will be of interest to anyone who follows the continuing growth and liberalisation of the Mainland economy.

We continued our efforts, in co-operation with the various financial intermediaries, to upgrade Hong Kong's already world-class financial infrastructure to ensure that investors and financial institutions find our city a safe and convenient place to do business.

The very high levels of turnover in the stock market illustrated just how important it is for the financial infrastructure not just to keep up with developments but to be ahead of them wherever possible. The Hong Kong-dollar Clearing House Automated Transfer System, which clears all Hong Kong-dollar interbank payments including those related to securities transactions, processed a daily average of \$879 billion in 2007 and, on 5 November, a record \$1.67 trillion passed through the system without incident. In these cases, the sheer capacity of the system is obviously a major consideration. A number of improvements were introduced during the year: these included a CCASS Optimiser to make it easier for banks to manage their funding; the Hong Kong-dollar RTGS and Central Moneymarkets Unit systems opening half an hour earlier; and an improved eIPO service introduced jointly with the Hong Kong Association of Banks and Hong Kong Interbank Clearing Limited to make liquidity management and the recycling of IPO funds back into the market more efficient. A renminbi RTGS system was introduced in June to support the expansion of renminbi-denominated business in Hong Kong. A link between the Hong Kong US-dollar RTGS system and Malaysia's securities settlement system was launched in October. An electronic bond-trading platform was introduced in December to improve price transparency and make bond trading more efficient.

There was also progress in the development of the debt market with the HKMA completing the second phase of its review of debt market development and submitting its recommendations to the Government. We also carried out a study, in co-operation with the Treasury Markets Association, on developing an Islamic financing platform in Hong Kong, in particular how our tax laws might be amended or clarified to provide a level playing field for the issuance of Islamic bonds. A number of refinements were also introduced in the Exchange Fund Bills and Notes Programme, including the publication of league tables for market makers and the first issue of 15-year Exchange Fund Notes.

Governance and transparency

On the currency front, the HKMA responded swiftly to the emergence in March of new counterfeits of the 2000- and 2002-series \$1000 notes issued by HSBC by alerting the public and giving information on how to identify the counterfeits. Speeding up the withdrawal of the old-series HSBC banknotes from circulation also helped contain the problem, which subsided in May. A new \$10 polymer note was put into circulation in the second half of the year to assess the performance and acceptability of polymer notes in Hong Kong.

Everyone at the HKMA strives to achieve the highest possible professionalism in fulfilling our responsibilities, and to be accountable to the community. We are aided in this by EFAC and its Sub-Committees, in particular the Governance Sub-Committee, whose wise advice is of great value to us. We also try to be as transparent as possible and this Annual Report has been expanded in a number of areas to include more information on how we carry out our work.

A particular challenge in 2007 was the turnover of staff. Although the overall figure was below 10%, it was the highest for some years and reached higher levels in some key departments as the economy continued to grow and the labour market tightened. Of course, turnover is inevitable in any organisation and, for a body like the HKMA, is healthy as long as it does not reach levels that undermine our ability to do our job. I am confident that that level has not been reached, but we will need to pay particular attention to how we can best retain staff, recruit replacements for those that do move on and to meet new and expanded responsibilities, and provide appropriate training and development to make the best use of our pool of talent. I am also keenly aware that too-rapid turnover creates additional pressure on staff.

Finally, as always I would like to express my thanks to my colleagues for their hard work and dedication in another busy and challenging year.



Joseph Yam
Chief Executive

About the HKMA

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

THE HKMA'S LEGAL MANDATE

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

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

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

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

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

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

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

 > The HKMA

THE HKMA AND THE HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT

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

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

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

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

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

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

ACCOUNTABILITY AND TRANSPARENCY

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

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

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

to-day operations and in its wider contacts with the community, the HKMA pursues a policy of transparency and accessibility. This policy has two main objectives:

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

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

 > [Viewpoint](#)

 > [HKMA Information Centre](#)

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

 > [Press Releases > Exchange Fund](#)

 > [Supervisory Policy Manual](#)

 > [Guidelines and Circulars](#)

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

 > [Legislative Council Issues](#)

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

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

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

About the HKMA

EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC. The Committee held six meetings in 2007 to discuss the full range of issues relating to the work of the HKMA, most of which had been previously discussed by the relevant Sub-Committees.

The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues. The Sub-Committee met seven times in 2007 to consider a range of subjects including disclosure of information on the HKMA's expenditure budget, the HKMA's performance assessment, the annual pay review, the *HKMA Annual Report*, strategic planning matters and a review of the HKMA's work on banking stability. The Sub-Committee also received regular reports on the work of the HKMA.

The *Audit Sub-Committee* reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits. None of the members of the Sub-Committee performs any executive functions in the HKMA. The Sub-Committee met twice in 2007.

The *Currency Board Sub-Committee* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. Records of the Sub-Committee's meetings and the monthly reports on Currency Board operations submitted to the Sub-Committee are published. In 2007 the Sub-Committee met four times.

 > [Press Releases > Monetary Policy](#)

The *Investment Sub-Committee* monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. The Sub-Committee held six meetings during 2007.

The *Financial Infrastructure Sub-Committee* monitors the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong and makes recommendations on measures and initiatives relating to the HKMA's responsibilities for promoting the safety, efficiency and development of Hong Kong's financial infrastructure. In 2007 the Sub-Committee met twice.

The Banking Advisory Committee

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

The Deposit-Taking Companies Advisory Committee

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

Chief Executive's Committee

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

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

 > [The HKMA > Advisory Committees](#)

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

Advisory Committees



K C Chan

Victor Lo

David Sun

Patrick Fung

Thomas Kwok

Henry Fan

Christopher Cheng

Joseph Yam

THE EXCHANGE FUND ADVISORY COMMITTEE

Chairman

The Hon. John TSANG Chun-wah, JP

The Financial Secretary
(from 1 July 2007)

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

The Financial Secretary
(until 30 June 2007)

Members

Mr Joseph YAM, GBS, JP

The Monetary Authority

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

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman
USI Holdings Limited

Mr HE Guangbei

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

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

Managing Director
CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, SBS, JP

Vice-Chairman and Managing Director
Sun Hung Kai Properties Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation Limited



John Tsang

Marvin Cheung

He Guangbei

Simon Ip

Vincent Cheng

Lawrence Lau

Peter Sullivan

Patrick Wang

Dr Patrick FUNG Yuk-bun

Chairman and Chief Executive
Wing Hang Bank Limited

Professor Lawrence J. LAU, JP

Vice-Chancellor
The Chinese University of Hong Kong
(from 1 October 2007)

Mr David SUN Tak-kei, BBS

Chairman and Managing Partner
Ernst & Young Far East Area & Greater China
(from 1 October 2007)

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
(until 31 December 2007)

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

Chairman and Chief Executive
Gold Peak Industries (Holdings) Limited
(until 9 December 2007)

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer
Johnson Electric Holdings Limited
(until 9 December 2007)

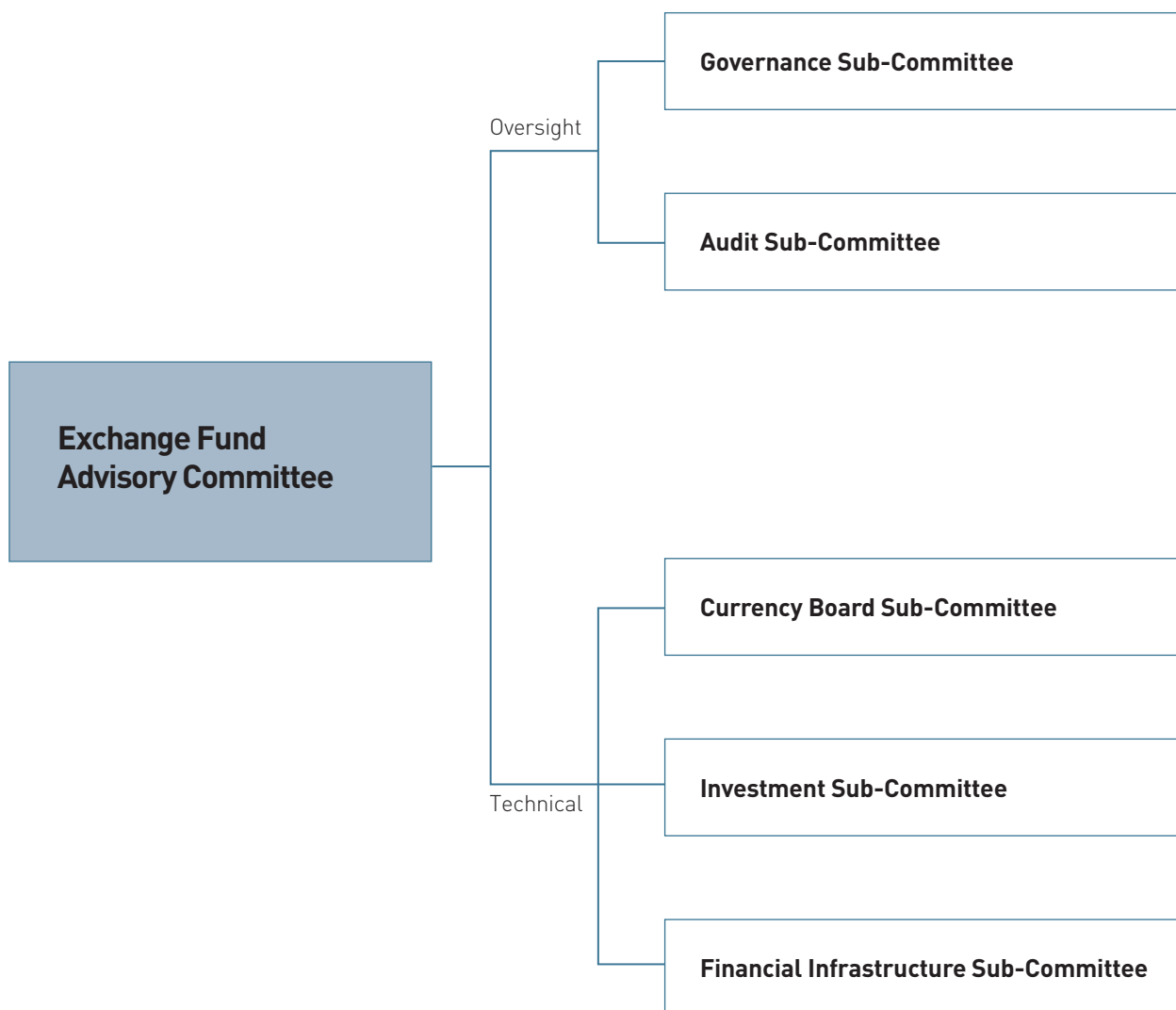
Professor K C CHAN, JP

Dean of Business and Management
Hong Kong University of Science and Technology
(until 30 June 2007)

Secretary

Mr Trevor KEEN

EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

Members

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

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

Managing Director

CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, SBS, JP

Vice-Chairman and Managing Director

Sun Hung Kai Properties Limited

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

Chairman and Chief Executive

Gold Peak Industries (Holdings) Limited

(until 9 December 2007)

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer

Johnson Electric Holdings Limited

(until 9 December 2007)

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology

(until 30 June 2007)

Secretary

Mr Trevor KEEN

Terms of reference

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

THE EXCHANGE FUND ADVISORY COMMITTEE AUDIT SUB-COMMITTEE

Chairman

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

Members

Mr HE Guangbei

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

Mr Simon IP Sik-on, JP

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman
The Hongkong and Shanghai Banking Corporation Limited

Mr David SUN Tak-kei, BBS

Chairman and Managing Partner
Ernst & Young Far East Area & Greater China
(from 1 October 2007)

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
(until 31 December 2007)

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

Managing Director
CITIC Pacific Limited
(until 20 November 2007)
(Mr Fan was Chairman at meetings in the absence of Dr Cheung)

Secretary

Mr Trevor KEEN

Terms of reference

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

- (2) The functions of the Sub-Committee include, but are not restricted to, the following:
- (a) reviewing the HKMA's financial statements, the composition and accounting principles adopted in such statements, whether these are intended to be audited or published or not;
 - (b) advising on the form and content of the financial statements of the HKMA;
 - (c) examining and reviewing with both the external and internal auditors the scope and results of their audits;
 - (d) reviewing the findings, recommendations or criticisms of the auditors, including their annual management letter and management's response;
 - (e) reviewing the HKMA's management procedures to ensure the effectiveness of internal systems of accounting and control, and management's efforts to correct deficiencies discovered in audits; and
 - (f) initiating investigations or audit reviews into any activities of the HKMA which may be of concern or interest to the Sub-Committee.

(3) Authority

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

(4) Meetings

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

THE EXCHANGE FUND ADVISORY COMMITTEE CURRENCY BOARD SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Mr Peter PANG, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Y K CHOI, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Eddie YUE, JP

Deputy Chief Executive

Hong Kong Monetary Authority

(from 1 September 2007)

Mr John GREENWOOD

Group Chief Economist

INVESCO Asset Management Limited

Professor TSANG Shu-ki

Department of Economics

Hong Kong Baptist University

Mr Peter SULLIVAN

Chairman

The Hong Kong Association of Banks

Professor Lawrence J. LAU, JP

Vice-Chancellor

The Chinese University of Hong Kong

(from 1 October 2007)

Mr William RYBACK, JP

Deputy Chief Executive

Hong Kong Monetary Authority

(until 31 August 2007)

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology

(until 30 June 2007)

Secretary

Mr Trevor KEEN

Terms of reference

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

THE EXCHANGE FUND ADVISORY COMMITTEE INVESTMENT SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Mr Eddie YUE, JP

Deputy Chief Executive

Hong Kong Monetary Authority

(from 1 September 2007)

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

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

Managing Director

CITIC Pacific Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

(until 31 December 2007)

Mr Y K CHOI, JP

Deputy Chief Executive

Hong Kong Monetary Authority

(until 31 August 2007)

Professor K C CHAN, JP

Dean of Business and Management

Hong Kong University of Science and Technology

(until 30 June 2007)

Secretary

Mr Trevor KEEN

Terms of reference

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

THE EXCHANGE FUND ADVISORY COMMITTEE FINANCIAL INFRASTRUCTURE SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Mr Eddie YUE, JP

Deputy Chief Executive

Hong Kong Monetary Authority

(from 1 September 2007)

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Dr Patrick FUNG Yuk-bun

Chairman and Chief Executive

Wing Hang Bank Limited

Dr Patrick WANG Shui-chung, JP

Chairman and Chief Executive Officer

Johnson Electric Holdings Limited

(until 9 December 2007)

Mr Y K CHOI, JP

Deputy Chief Executive

Hong Kong Monetary Authority

(until 31 August 2007)

Secretary

Mr Trevor KEEN

Terms of reference

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

THE BANKING ADVISORY COMMITTEE

Chairman

The Hon. John TSANG Chun-wah, JP

The Financial Secretary
(from 1 July 2007)

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

The Financial Secretary
(until 30 June 2007)

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Professor The Hon. K C CHAN, SBS, JP

Secretary for Financial Services and the Treasury
(from 1 July 2007)

Mr HE Guangbei

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

Mr Peter WONG Tung-shun, JP

Executive Director
The Hongkong and Shanghai Banking Corporation Limited
Representing The Hongkong and Shanghai Banking Corporation Limited

Mr Peter SULLIVAN

Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
Representing Standard Chartered Bank (Hong Kong) Limited
(until 31 December 2007)

Mrs Doreen CHAN HUI Dor-lam

President and Chief Executive Officer
CITIC Ka Wah Bank Limited

Mrs Mignonne CHENG

Head of North and East Asia
BNP Paribas

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

Chairman and Chief Executive
The Bank of East Asia Limited

Mr James C K WONG

Chief Executive Officer
Dah Sing Life Assurance Company Limited

Mr Stanley Y F WONG, JP

Director & Deputy General Manager
Industrial and Commercial Bank of China (Asia) Limited

Ms Maria XUEREB

Financial Services Partner
Deloitte Touche Tohmatsu

Mr Takaaki KATO

General Manager
Mizuho Corporate Bank, Ltd.
Hong Kong Branch
(from 25 May 2007)

Mr Sim S LIM

Citi Country Officer, Hong Kong
Head of Markets & Banking, Hong Kong & Taiwan
Citibank, N.A.
(from 10 October 2007)

Mr Hideo HIYAMA

Director, General Manager & Regional Chief Executive
Sumitomo Mitsui Banking Corporation
Hong Kong Branch
(until 24 April 2007)

Mr Ignatius CHAN Tze-ching, JP

Citigroup Country Officer, Hong Kong & Head of Greater China
Corporate and Investment Banking
Citibank, N.A.
(until 18 May 2007)

The Hon. Frederick MA Si-hang, JP

Secretary for Financial Services and the Treasury
(until 30 June 2007)

Mr Atul MALIK

Country Business Manager, Hong Kong & Macau
Citibank (Hong Kong) Limited
(from 22 June until 30 August 2007)

Secretary

Ms Theresa KWAN

(from 4 May 2007)

Ms Jasmin FUNG

(until 3 May 2007)

THE DEPOSIT-TAKING COMPANIES ADVISORY COMMITTEE

Chairman

The Hon. John TSANG Chun-wah, JP

The Financial Secretary
(from 1 July 2007)

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

The Financial Secretary
(until 30 June 2007)

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Professor The Hon. K C CHAN, SBS, JP

Secretary for Financial Services and the Treasury
(from 1 July 2007)

Mr Martin WHEATLEY

Chief Executive Officer
Securities and Futures Commission
Representing the Securities and Futures Commission

Mr Geoffrey J MANSFIELD

Chairman
The DTC Association (The Hong Kong Association of Restricted Licence
Banks and Deposit-taking Companies)
Representing The DTC Association

Ms Connie LAU Yin-hing

Chief Executive
Consumer Council
Representing the Consumer Council
(from 1 April 2007)

The Hon. CHAN Kam-lam, SBS, JP

Member
Legislative Council

Mr Michael CHANG Ming-yuen

Chairman
Fubon Credit (Hong Kong) Limited

Mr CHOI Jong Ha

Managing Director and Chief Representative
KDB Asia Limited

Ms Kitty IU Pui-pui

Managing Director
Scotiabank (Hong Kong) Limited

Mr Mervyn JACOB

Partner
Assurance, Financial Services Practice
PricewaterhouseCoopers

Mr Frank J WANG

Executive Director and Deputy Chief Executive
Wing Hang Finance Company Limited

Mr Erik Helge WEINER

Chairman & Chief Executive
JP Morgan Securities (Asia Pacific) Limited

Mr Frederick CHIN

Chief Executive
Banc of America Securities Asia Limited
(from 30 August 2007)

Mrs Pamela CHAN WONG Shui, BBS, JP

Chief Executive
Consumer Council
Representing the Consumer Council
(until 31 March 2007)

The Hon. Frederick MA Si-hang, JP

Secretary for Financial Services and the Treasury
(until 30 June 2007)

Mr Yasuhiro MATSUMURA

Chairman
Mitsubishi UFJ Securities (HK) Capital, Limited
(until 10 July 2007)

Secretary

Ms Theresa KWAN

(from 4 May 2007)

Ms Jasmin FUNG

(until 3 May 2007)

Chief Executive's Committee



CHIEF EXECUTIVE

Joseph YAM, GBS, JP

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



DEPUTY CHIEF EXECUTIVE

Peter PANG, JP

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



DEPUTY CHIEF EXECUTIVE

Y K CHOI, JP

Y K Choi is in charge of the full range of banking policy, development and supervision issues at the HKMA. Mr Choi started his career as a central banker in 1974 when he joined the then Office of the Commission of Banking, which was responsible for banking supervision in Hong Kong at that time. He advanced to the rank of Assistant Commissioner of Banking in 1990 and was appointed Head (Banking Policy) upon the establishment of the HKMA in 1993. He was then appointed Executive Director (Banking Supervision) in 1995 and advanced to the position of Deputy Chief Executive in June 2005 to take charge of monetary management, financial infrastructure, reserves management, and strategy and risk issues until transfer to the current position in September 2007.



DEPUTY CHIEF EXECUTIVE

Eddie YUE, JP

Eddie Yue is responsible for monetary management, reserves management and financial infrastructure. Mr Yue began his career as an Administrative Officer in the Hong Kong Government in 1986. He joined the HKMA in 1993 as a Senior Manager, and was subsequently promoted to Division Head in 1994. He has worked in a number of divisions, including Monetary Management, External Relations, and Banking Development, and has served as Administrative Assistant to the Chief Executive of the HKMA. Mr Yue was appointed Executive Director in 2001 and to his present position in September 2007.

DEPUTY CHIEF EXECUTIVE

William RYBACK, JP

William Ryback, who left the HKMA at the end of August 2007, was responsible for banking policy, development and supervision issues.



GENERAL COUNSEL

Stefan GANNON, JP

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



EXECUTIVE DIRECTOR (BANKING DEVELOPMENT)

Raymond LI, JP

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



EXECUTIVE DIRECTOR (EXTERNAL)

Julia LEUNG, JP

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



EXECUTIVE DIRECTOR (BANKING SUPERVISION)

Arthur Yuen, JP

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



EXECUTIVE DIRECTOR (RESEARCH)

Hans GENBERG

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



EXECUTIVE DIRECTOR (MONETARY MANAGEMENT)

Edmond LAU, JP

Edmond Lau is responsible for monetary management, and examining and developing strategic responses to the impact on the HKMA's policies and operations of such processes as the globalisation and liberalisation of financial markets and technological change. Mr Lau joined the HKMA in 1997 as Head (Banking Development) and has been involved in banking reform and the establishment of the Deposit Protection Scheme. He took up position as Administrative Assistant to the Chief Executive of the HKMA in 2004 after a one-year secondment to the Financial Services and Treasury Bureau and appointed Executive Director (Strategy and Risk) in June 2005, before appointed to his present position in September 2007. Before joining the HKMA Mr Lau was an Administrative Officer in the Hong Kong Government.



EXECUTIVE DIRECTOR (CORPORATE SERVICES)

Christopher MUNN, JP

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



EXECUTIVE DIRECTOR (RESERVES MANAGEMENT)

Francis CHU, JP

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



EXECUTIVE DIRECTOR (FINANCIAL INFRASTRUCTURE)

Esmond LEE

Esmond Lee is responsible for financial infrastructure. He joined the HKMA in 1993 as Head (Market Systems). From 1998 to 2000, he was the HKMA's Chief Representative in New York. Since returning to Hong Kong in 2000, he served again as Head (Market Systems) before his promotion to the current position in February 2008. Before joining the HKMA, Mr Lee was a principal economist in the Hong Kong Government.



EXECUTIVE DIRECTOR (BANKING POLICY)

Karen KEMP

Karen Kemp has been employed by the HKMA since 1995. She was a Deputy General Counsel in the Office of the General Counsel prior to being appointed to her current post in February 2008. Ms Kemp also served as Deputy Chief Executive Officer of Exchange Fund Investment Limited from 1999 to 2003. Ms Kemp is a solicitor qualified to practise in Hong Kong and in England & Wales. Prior to joining the HKMA, Ms Kemp was employed by Lovells (a firm of solicitors) in London and Hong Kong.



CHIEF EXECUTIVE OFFICER (HONG KONG MORTGAGE CORPORATION)

James H LAU Jr, JP

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

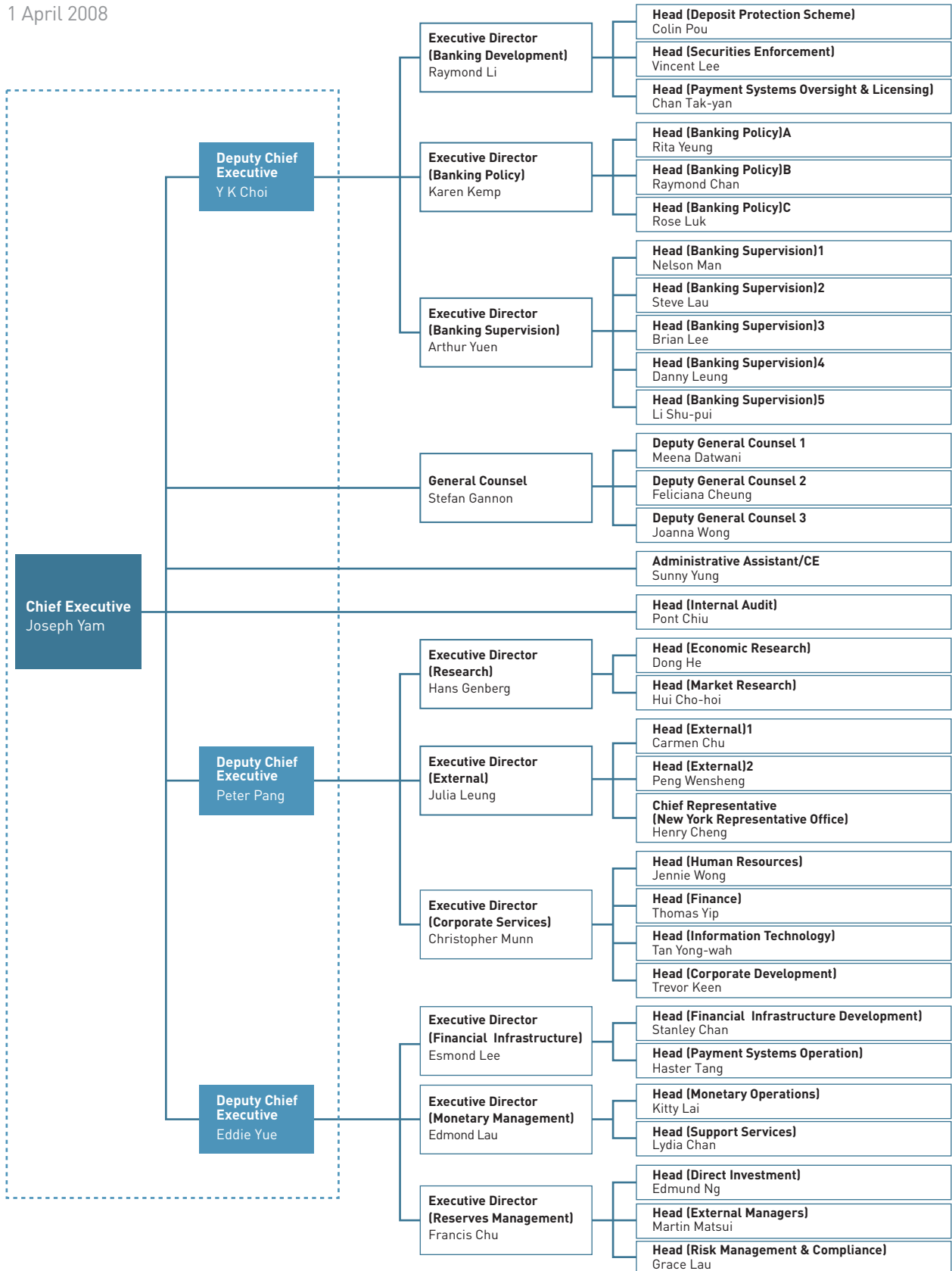
EXECUTIVE DIRECTOR (BANKING POLICY)

Simon TOPPING, JP

Simon Topping left the HKMA in April 2008.

HKMA Organisation Chart

1 April 2008





Economic and Banking Environment

The Hong Kong economy maintained a strong momentum in 2007, recording above-trend growth for the fourth consecutive year. Growth was mainly driven by strong domestic demand, boosted by rising labour income and buoyant asset markets. The outlook for 2008 remains solid, although subject to a number of external uncertainties.

THE ECONOMY IN REVIEW

Overview

Real GDP grew by 6.3%, following the healthy 7.0% growth in 2006. Domestic demand and service exports picked up strongly, while growth in merchandise exports moderated (Table 1). More jobs were created, driving down the unemployment rate to its lowest point in nearly 10 years. Although headline inflation in 2007 remained low at 2.0%, underlying inflation accelerated on strong domestic demand and rising prices of retained imports, particularly those of imported food products.

Monetary conditions eased further, with monetary aggregates and domestic loans growing at a brisk pace. For the year as a whole, broad money picked up by 18.1% and domestic credit by 15.7%. Interest rates also moved lower following the US rate cuts amounting to 100 basis points that began in September 2007. The loan-to-deposit ratio declined to a record low towards the end of the year, suggesting a prudent approach to credit quality by individual banks and abundant liquidity in the banking system.

Table 1. Contribution to real GDP growth by expenditure components (% yoy)

	2007					2006				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	2.6	3.5	5.8	5.7	4.5	3.7	4.4	2.6	3.4	3.5
Government Consumption Expenditure	0.2	0.2	0.1	0.2	0.2	0.1	-0.1	-0.1	0.1	0.0
Gross Domestic Fixed Capital Formation	0.6	2.2	0.2	2.1	1.3	1.4	0.9	2.0	1.5	1.5
Change in Inventories	0.8	1.2	0.8	1.7	1.2	1.2	0.5	-0.8	0.2	0.2
Net Exports of Goods	-1.3	-3.3	-3.6	-5.1	-3.4	-0.2	-1.2	0.6	-0.3	-0.3
Net Exports of Services	2.5	2.6	3.0	2.2	2.6	2.8	1.7	2.1	1.7	2.1
GDP	5.5	6.4	6.3	6.7	6.3	9.0	6.2	6.4	6.6	7.0

Source: Census and Statistics Department.

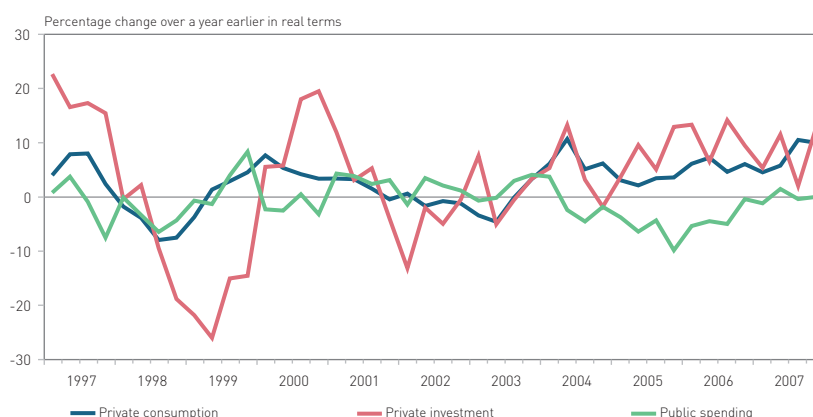
Buoyant domestic demand

Domestic demand continued to be the driving force of economic growth. Rising labour income and buoyant asset markets helped boost private consumption, which increased by 7.8% year on year compared with 6.0% in 2006. Owing to favourable monetary conditions, business investment in equipment spending rose further by 6.0%, after expanding by 19.9% in 2006. In particular, construction spending rebounded significantly following a four-year contraction. Improving fiscal conditions also helped reduce the decrease in government expenditure, which declined slightly by 0.2% in 2007 (Chart 1).

Solid export growth

Hong Kong's exports continued to perform well in 2007 with exports of services again showing strong growth. Merchandise export growth moderated to 7.2% from 9.3% in 2006, reflecting a slower global economy in the second half of the year. Mainland China consolidated its position as Hong Kong's largest trading partner, with the US a distant second and the European Union third (Table 2). Retained imports of goods rose by 9.5%, compared with the 7.7% growth in 2006, boosted by the stronger domestic demand. While the merchandise trade deficit in real terms widened to \$112.9 billion (7.2% of real GDP) in 2007 from \$62.9 billion (4.3% of real GDP) in 2006, exports

Chart 1. Domestic demand



Source: Census and Statistics Department.

Table 2. Merchandise exports by major trading partners¹

	Share %	2007					2006				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	49	13	16	13	11	13	18	8	13	17	14
United States	14	2	1	-2	-3	-1	4	0	1	7	3
European Union	14	5	7	6	6	6	9	4	2	6	5
Japan	4	2	4	-6	-1	-1	7	2	0	-2	1
ASEAN5 ² + Korea	7	5	11	7	11	9	8	2	13	7	8
Taiwan	2	4	11	-4	-2	2	4	-7	9	7	3
Others	10	14	20	17	20	18	11	7	9	17	11
Total	100	9	12	8	8	9	12	5	8	12	9

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

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

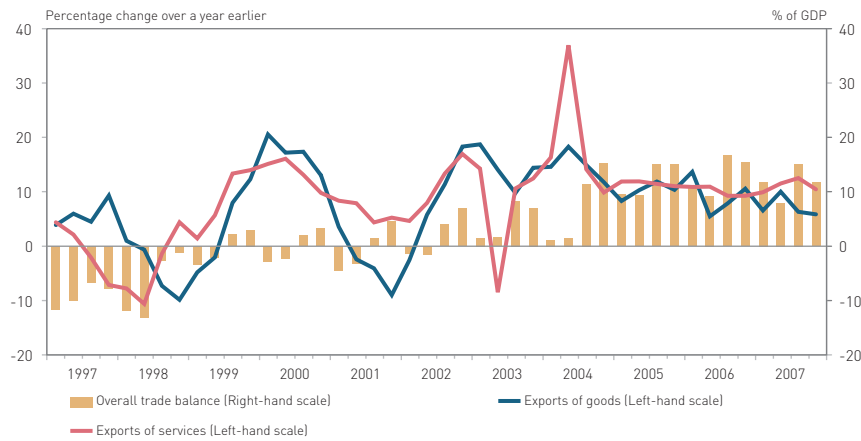
Source: Census and Statistics Department.

of services (particularly financial and tourism-related services) increased faster than imports of services, resulting in an overall trade surplus of \$184.8 billion (11.8% of real GDP), compared with \$196.8 billion (13.3% of real GDP) in 2006 (Chart 2).

Rising inflationary pressures

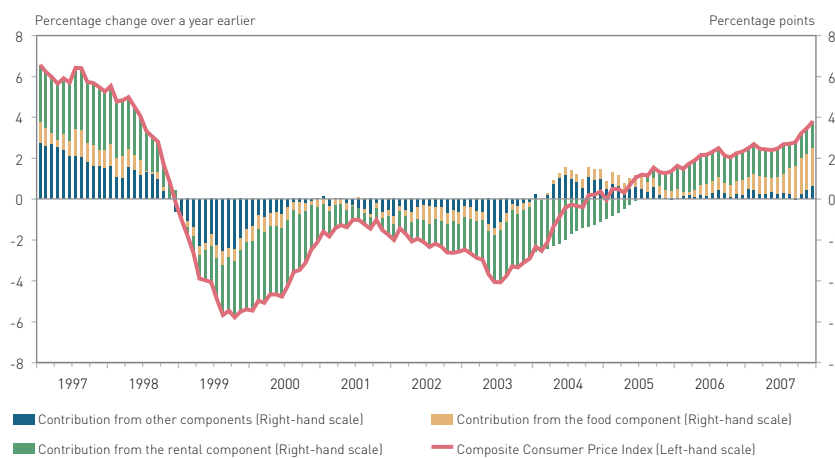
Underlying inflation increased at a faster pace in 2007, rising to an average of 2.8% from 2.0% in 2006, mainly driven by higher residential rents and imported food prices (Chart 3). Rising inflationary pressures were due to an extended period

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



Source: Census and Statistics Department.

Chart 3. Consumer prices¹



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

Sources: Census and Statistics Department and staff estimates.

of above-trend economic growth and the weak US dollar, to which the Hong Kong dollar is pegged. The headline CCPI inflation rate, however, remained subdued at 2.0%, because of one-off government measures, particularly the rebate of property rates.¹

Tight labour market

Labour market conditions continued to tighten, reflecting the extended period of strong economic growth. In 2007, the seasonally adjusted unemployment rate declined to 3.4% in December from 4.4% in January, the lowest level in nearly 10 years. Employment in sectors such as finance, trade and tourism enjoyed the fastest growth (Chart 4). The fall in the unemployment rate was also due to faster growth in employment than in the labour force.

The tight labour market helped push up nominal wages. The nominal payroll per worker, which includes wages and other non-regular allowances and bonuses,

increased by 3.3% in the first three quarters of 2007 over a year earlier, after growing by 2.4% in 2006. However, rising labour costs were largely offset by a sustained improvement in labour productivity growth. As a result, unit labour costs remained stable.

Booming but volatile stock market prices

The Hang Seng Index (HSI) increased by 39% in 2007, the largest annual gain since 2003. However, market volatility also increased significantly. Apart from strong economic fundamentals, the rise in the Index was also propelled by the expansion of the Qualified Domestic Institutional Investors scheme on the Mainland, expectations that individual Mainland investors would eventually be able to invest directly in the Hong Kong stock market, and the US interest rate cuts after August 2007. Although the global credit market turmoil affected local sentiment significantly, the subsequent rate cuts by the Fed helped sustain the gains. The Index surged briefly to a record



Source: Census and Statistics Department.

¹ Rates are an indirect tax levied on properties. They are charged at a percentage of the rateable value (the estimated annual rental value of a property at a designated valuation reference date, assuming that the property was then vacant and to let). For the financial year 2007/08, the rates percentage charge is 5% and the designated valuation reference date is 1 October 2006.

high of 31,638 at the end of October 2007 before falling back to the 27,000 level towards the end of the year, as investors became increasingly concerned about the sustainability of the high stock valuations, risk appetite fell and profit taking set in. The H-share index, consisting of Mainland firms listed in the Hong Kong market, rose strongly by 56% and was also highly volatile during the year, largely reflecting its lower valuation relative to the A-share market and strong demand for shares of Chinese enterprises among institutional investors.

Rising property prices

The residential property market picked up markedly in 2007 on growing household income and easing monetary conditions. Residential housing prices in 2007 rose by 11.6% year on year after an increase of only 0.8% in 2006, while residential property transactions expanded sharply by 47%. In the light of falling real interest rates, property prices are expected to rise further, thus raising concerns of more property price inflation. The average transacted price of luxury flats (160 m² or above) on Hong Kong Island breached the peak level seen in 1997, while luxury flat prices in other areas rose close to their record highs. Nevertheless, various indicators suggest developments in the housing market remained healthy in 2007. The income-gearing ratio remained relatively low and the affordability of housing continued to improve because of falling real mortgage rates and rising incomes.

Notes and coins

At the end of 2007, the total value of banknotes in circulation was \$163,435 million, an increase of 3.8% from a year earlier (Charts 5, 6, 7). The total value of government-issued notes and coins in circulation amounted to \$7,318 million, up 10.3% (Charts 8 and 9). The value of \$10 notes issued by the Government in circulation (both paper and polymer notes) reached \$2,068 million, an increase of 36.5% from 2006.

Chart 5. Banknotes in circulation by note-issuing banks at the end of 2007

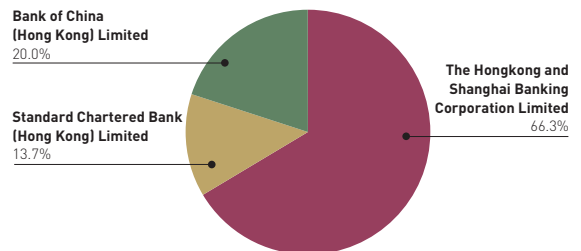
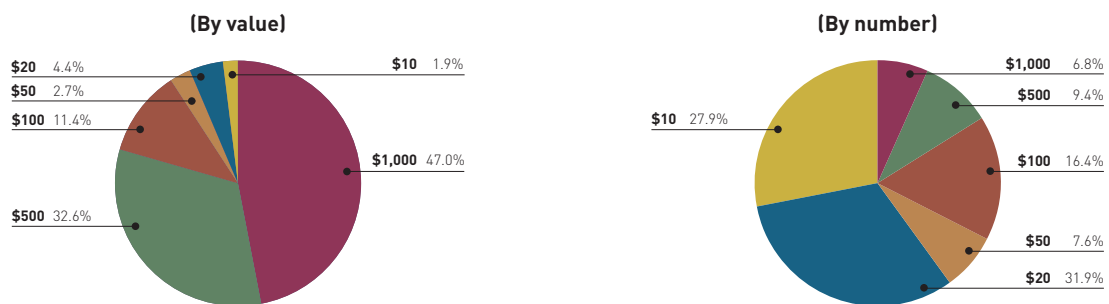


Chart 6. Distribution of banknotes in circulation at the end of 2007



Economic and Banking Environment

Chart 7. Banknotes in circulation at the end of year

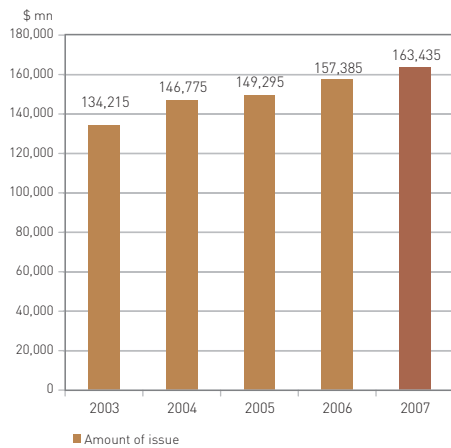


Chart 8. Government-issued notes and coins in circulation at the end of year

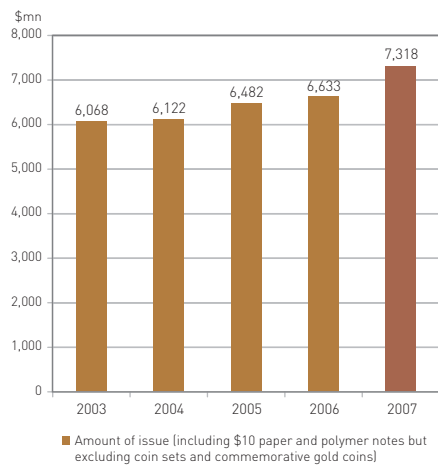
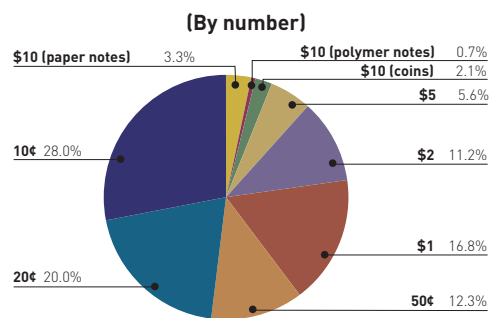
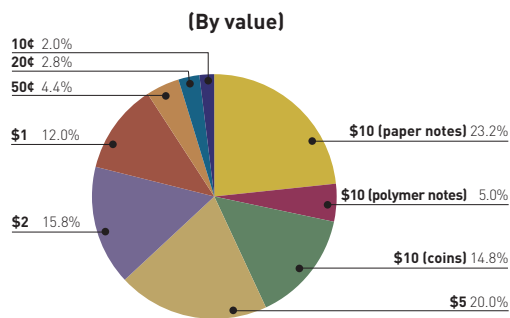


Chart 9. Government-issued notes and coins in circulation at the end of 2007



Hong Kong banknotes

Public education programmes on the security features of the latest series of banknotes issued in 2003 and 2004 continued to be well received. During the year, 49 seminars were organised for over 7,000 bank tellers and retail cashiers, providing them with knowledge and skills for authenticating banknotes.

The HKMA responded swiftly, alerting banks and the public, to the emergence in March 2007 of new counterfeit notes of the 2000- and 2002-series \$1,000 notes issued by The Hongkong and Shanghai Banking Corporation (HSBC). Seminars were organised for bank tellers, retailers and moneychangers to advise them on how to identify the new counterfeit notes. Speeding up the withdrawal of the old-series HSBC banknotes from circulation also helped contain the problem, which subsided in May.

The HKMA continued with its efforts to promote the use of “good-as-new” notes instead of brand new notes for *lai see* (customary monetary gifts given during Chinese New Year). Thanks to the support of the public and the three note-issuing banks, the number of new \$10, \$20 and \$50 notes issued for the 2007 Chinese New Year decreased by 22% compared with 2006.

\$10 polymer note

The Hong Kong \$10 polymer note was put into circulation in July 2007. The HKMA, which has been examining alternative technologies for the production of currency notes, issued the note to assess the performance and acceptability of polymer notes in Hong Kong.



Mr Henry Tang, then Financial Secretary, and HKMA student ambassadors at an exhibition of the \$10 polymer note.

An extensive publicity campaign including exhibitions at public housing estates was launched during the year to brief the public on the characteristics of the notes. In November, the Community Chest held a charity sale of a special edition of the \$10 polymer notes bearing a serial number without an alphabetical prefix. The sale raised more than \$5.8 million to help improve social services for the mentally handicapped.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with 38 million coins being removed from circulation in 2007.

 > [Consumer Information > Notes & Coins](#)

OUTLOOK FOR THE ECONOMY

Economic growth to continue

Economic growth is expected to remain solid in 2008, although growth momentum is likely to moderate. Domestic demand will continue to provide the main impetus, with increasing private consumption expenditure underpinned by income and wage growth amid favourable labour market conditions, aided by the positive wealth effect associated with buoyant asset markets. Low real interest rates and buoyant asset markets should also boost fixed-asset investment, but increased uncertainty about the outlook for the US economy may affect investment sentiment. Merchandise exports are projected to moderate, mainly due to a possible US-led global slowdown and a sustained appreciation of the renminbi, which would reduce Hong Kong's re-exports from the Mainland to the rest of the world. However, the moderation in export growth is likely to be offset, to some extent, by the weak US dollar. Exports of services are expected to remain steady, in part supported by an anticipated increase in tourists to the Mainland transiting Hong Kong, particularly during the 2008 Beijing Olympics. The market consensus forecasts a slowdown in real GDP growth from 6.3% in 2007 to 4.9% in 2008, driven largely by a deceleration in external demand.

Inflationary pressures to increase

Barring a significant slowdown in the global economy, strong domestic demand and the weak US dollar will continue to put upward pressure on domestic inflation. In particular, rising property prices will push up private housing rents, leading to rising inflation in the CCPI rental component. Although the rapid labour productivity growth has mitigated some of the inflationary pressures in previous years, the non-rental component of CCPI inflation is also expected to rise faster, largely reflecting strong domestic demand. While headline inflation was lower than the underlying inflation rate in 2007, it is expected to converge to the level of underlying inflation once the effects of special government tax-relief measures are phased out, especially those relating to the rebate of property rates.

Uncertainties and risks

The solid baseline outlook for 2008 is subject to a number of risks and uncertainties, mainly led by external factors. A sharper-than-expected slowdown in the US would have a particularly adverse effect on re-export trade between Hong Kong and the Mainland. As global investors re-balance their portfolios reflecting the turmoil in developed financial markets, there could be increased market volatility in Hong Kong, which may undermine consumer and business confidence. Nevertheless, even if these risks were to materialise, Hong Kong should still be able to achieve positive growth, largely because of its strong economic fundamentals. A further tightening of labour market conditions and a larger-than-expected increase in housing rentals would be important risk factors for inflation. The prospect of rising inflation and lower real interest rates could help fuel domestic credit growth and stimulate the build-up of leveraged positions. It is therefore important for financial institutions to manage risks prudently in an environment of rising asset prices.

 > [Publications > Half-Yearly Monetary and Financial Stability Report](#)

 > [Statistics](#)

PERFORMANCE OF THE BANKING SECTOR

The banking sector remained sound in 2007, with retail banks highly profitable and locally incorporated authorized institutions (AIs) well capitalised. Stable macroeconomic conditions underpinned profitability and kept credit losses low.

Retail banks' balance sheets continued to grow in a stable operating environment. Strong growth in domestic lending, supported particularly by the buoyant domestic stock market, and the improvement in net interest margins contributed to a significant increase in net interest income. Profit growth was also supported by continued robust growth in fees and commission income, which was mainly associated with equity-related business and accounted for a larger share of total income.

Asset quality remained very good, notwithstanding that the quality of investment in debt securities worsened mainly due to the sub-prime turmoil. The number of negative-equity residential mortgages declined further. Although the quality of the credit card portfolio showed signs of weakening alongside an increase in personal bankruptcies, the charge-off ratio remained low.

Interest rate trends

Hong Kong dollar interest rates were stable in the first half of the year until the sub-prime problem emerged. Sparked by a tightening of global liquidity, Hong Kong dollar interbank interest rates rose. A decline in best lending rates following interest-rate cuts by the Federal Reserve in September mitigated the impact briefly, but it was not until the Hong Kong dollar exchange rate moved from the strong side to the middle of the Convertibility Zone following the market operations conducted in October by the HKMA under the Currency Board arrangements that interest rates in Hong Kong began to soften. Amid the higher volatility, the average one-month Hong Kong Interbank Offered Rate (HIBOR) increased to 4.29% in 2007 from 4.12% in 2006. Under the influence of an easing US monetary policy, best lending rates declined to 6.75% or 7.00% at the end of 2007. Deposit rates moved in tandem with best lending rates. The average one-month time deposit rate declined to 2.42% in 2007 from 2.70% in 2006 (Table 3). The spread between the average best lending rate of The Hongkong and Shanghai Banking Corporation and the average one-month HIBOR narrowed to 331 basis points compared with 378 in 2006. However, the spread between the annual average best lending rate and the average one-month time deposit rate was little changed at 517 basis points, compared with 520 in 2006.

Table 3. Hong Kong-dollar interest-rate movements (period average figures)

% per annum	Time deposits			HIBOR			Savings deposits	Best lending rate*
	1-month	3-month	12-month	1-month	3-month	12-month		
Q1-2007	2.52	2.58	2.82	4.08	4.15	4.35	2.26	7.75
Q2-2007	2.55	2.59	2.86	4.40	4.38	4.53	2.26	7.75
Q3-2007	2.58	2.62	2.88	4.62	4.64	4.68	2.23	7.72
Q4-2007	2.04	2.29	2.62	4.04	4.17	4.07	1.66	7.15
2006	2.70	2.78	3.02	4.12	4.27	4.52	2.50	7.90
2007	2.42	2.52	2.80	4.29	4.33	4.41	2.10	7.59

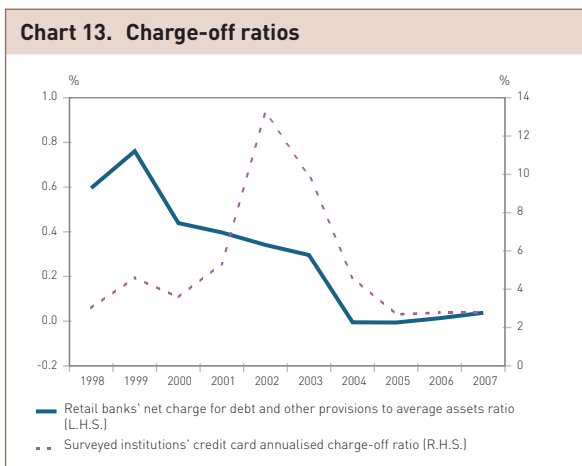
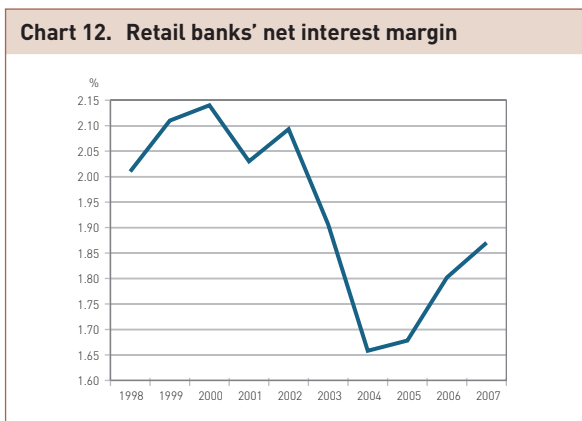
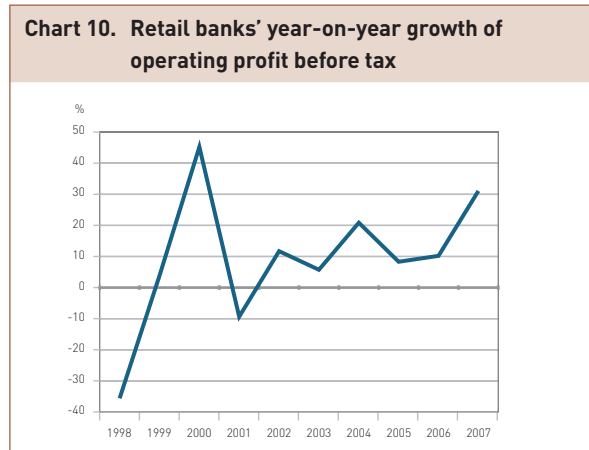
* Refers to the best lending rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices increased strongly by 31.1% following a 10.2%^r increase in 2006 (Chart 10). Post-tax return on average assets climbed to 1.53% from 1.36%^r in 2006 (Chart 11) as profits grew faster than the amount of assets.

The strong profit growth was mainly attributable to an increase in net interest income, reflecting both an expansion of assets and an improving net interest margin, which widened to 1.87% from 1.80% in 2006 (Chart 12). Retail banks posted sharp increases in fees and commission income and trading investment income, as a result of which the proportion of non-interest income to total income increased to 44.1% from 38.4% in 2006.

Retail banks' net charge for debt provisions more than tripled compared with 2006, as the amount of provision write-back decreased and new provisions increased in the year. Because of the deterioration in the quality of investment portfolios in relation to banks' exposure to sub-prime related products, the banks' net charge for other provisions also grew sharply to \$1.3 billion from a nearly zero-base in 2006. Nevertheless, retail banks' net charge for debt and other provisions to average assets ratio remained relatively low, at 0.06% at the end of 2007 (Chart 13).



^r 2006 figures revised.

Reflecting the favourable economic conditions and the tighter labour market, staff expenses continued to rise, while business expansion also drove operating costs higher. However, the faster increase in income than in operating costs resulted in a decline in retail banks' cost-to-income ratio to 40.4% from 42.8%^r in 2006 (Chart 14).

Balance sheet trends

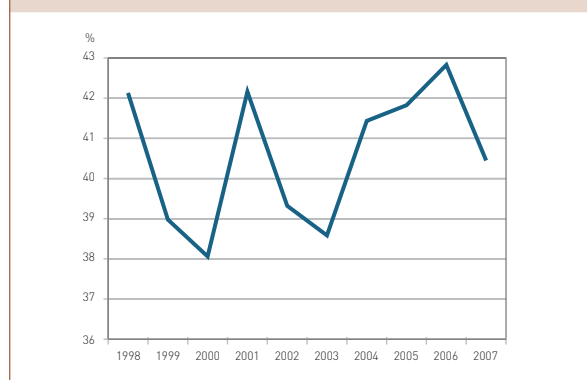
Total assets of the banking sector expanded by 24.6% and those of the retail banks by 17.6%. This mainly reflected the continuing growth of domestic lending. Supported by

steady economic growth, retail banks' customer deposits registered strong growth. With customer deposits increasing more than loans and advances, retail banks were less reliant on negotiable debt instruments (NDIs) for funding.

Domestic loan demand grows

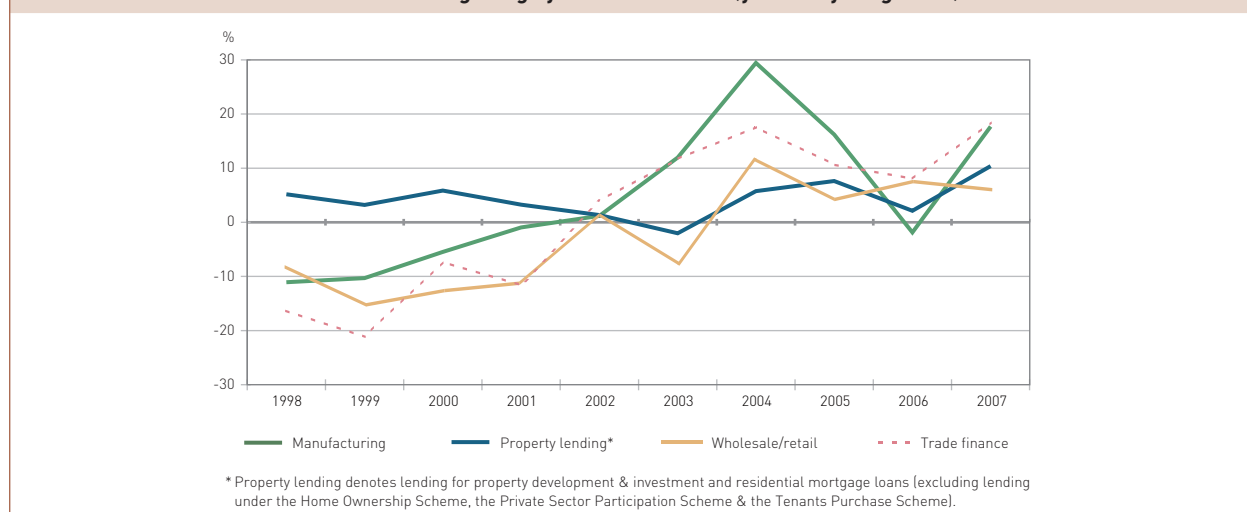
Retail banks' total lending rose by 12.6% in 2007 across a broad range of business. Domestic lending increased by 11.4% compared with an increase of 2.7%^r in 2006. Loans for use outside Hong Kong increased by 29.7% due to the small-base effect.

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



Strong growth was seen in property lending, which increased by 10.4% compared with 2.1% in 2006 (Chart 15), as sentiment improved and property prices increased throughout the year. Loans for property investment increased by 20.1% and those for property development by 6.7%, after growing by 5.5% and 9.7% respectively in 2006. Residential mortgage loans rebounded to grow by 5.5% because of lower best lending rates and higher market activity, reversing a decline of 0.9% in 2006.

Chart 15. Retail banks' loans for use in Hong Kong by selected sectors (year-on-year growth)



^r 2006 figures revised.

The economic growth momentum stimulated credit demand from trade financing and the manufacturing sector. Trade-financing loans rose by 18.4% following an increase of 8.0%^r in 2006. Loans to the manufacturing sector rose by 17.7%, reversing a 1.9%^r decline in 2006. Lending to the wholesale and retail trade sector grew by 6.0% and to the information technology sector by 6.8%. Lending to the electricity and gas sector continued to contract, declining by 11.4% after a drop of 13.1% in 2006.

Growth in share financing was strong, mainly because of the buoyant domestic stock market and the large number of initial public offerings (IPOs) during the year. Within this portfolio, loans to stockbrokers increased by 79.9% following a 28.4%^r increase in 2006, and loans to non-stockbroking companies and individuals to purchase shares also rose by 44.0% following an increase of 44.0%^r in 2006. Despite the strong growth, the proportion of these loans in overall domestic lending remained small.

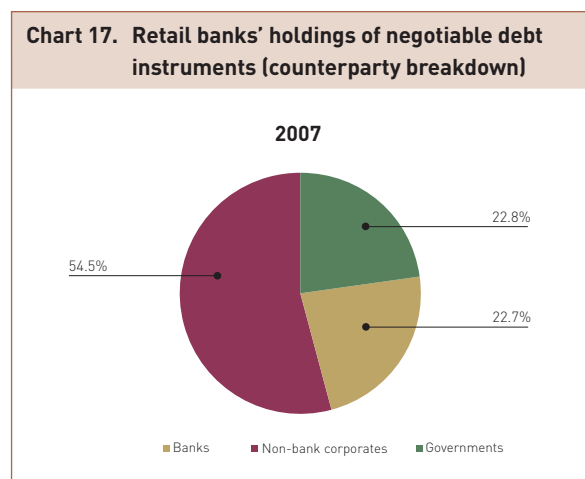
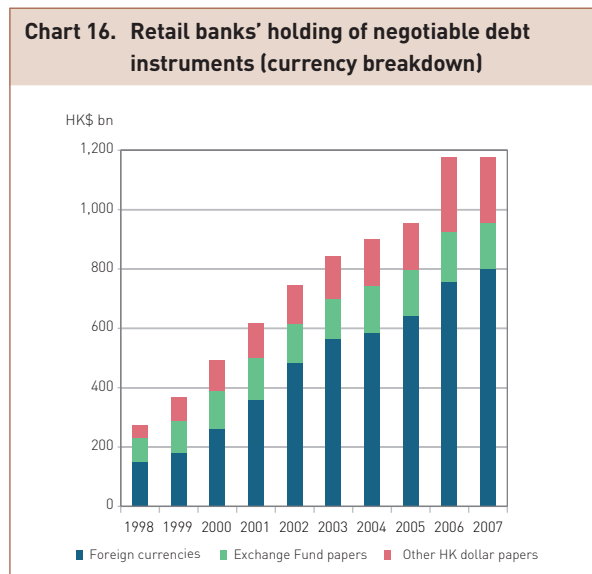
Credit card lending expanded further. According to the regular survey of AIs active in credit card business, total credit card receivables increased by 6.5% after an increase of 6.1% in 2006.

Retail banks' reported exposures to non-bank Chinese entities stood at \$550 billion, or 7.8% of their total assets, at the end of 2007 compared with \$426 billion (7.3% of total assets) at the end of 2006. For the banking sector as a whole, the exposures were \$756 billion (6.5% of total assets).

Holdings of negotiable debt instruments remained stable

Retail banks' holdings of NDIs (excluding negotiable certificates of deposits (NCDs)) remained little changed after increasing by 23.2% in 2006. NDIs denominated in Hong Kong dollars fell by 10.4%, while foreign-currency-denominated NDIs rose by 5.8% (Chart 16). A majority of NDIs were issued by non-bank corporates (54.5%), while 22.8% were issued by governments and 22.7% by banks (Chart 17). The share of retail banks' total holdings of NDIs to their total assets decreased to 20% at the end of 2007 from about 24% a year earlier.

Retail banks were less reliant on issuing NCDs for funding purposes as customer deposits grew rapidly, outpacing the growth in loans. Outstanding NCDs issued fell by 34.5% in 2007 after contracting by 12.7% in 2006.



^r 2006 figures revised.

Customer deposits rise

Retail banks' customer deposits expanded by 18.4% after increasing 15.6% in 2006 (Chart 18). Hong Kong dollar and foreign currency deposits increased by 17.1% (Chart 19) and 20.3% respectively. The proportion of Hong Kong dollar deposits to total deposits remained stable at 60%. Deposit growth was greatest at shorter maturities, reflecting the increased transaction demand for money arising from the strong domestic stock market and heavy IPO activities in 2007. Demand deposits therefore recorded strong growth of 33.4% after a 17.2% increase in 2006, while savings deposits increased by 19.3% following a 19.3% growth in 2006. Despite the lower average time deposit rates, time deposits rose further by 15.8%, following an increase of 13.3% in 2006. At the end of 2007, savings and demand deposits together accounted for 43.5% of total deposits, up from 42.3% a year earlier.

Retail banks remain highly liquid with good asset quality

Retail banks remained highly liquid in 2007. Faster growth in customer deposits relative to loans drove loan-to-deposit ratios in all currencies down to 45.5% and those in Hong Kong dollars to 65.1%.

The asset quality of retail banks remained sound. The classified loan ratio and the ratio of loans overdue for more than three months reached the new lows of 0.86% and 0.36% respectively, compared with 1.11% and 0.54% at the end of 2006. With the rescheduled loan ratio also declining, the combined ratio of overdue and rescheduled loans fell further to 0.57% from 0.80% (Chart 20).

Chart 18. Retail banks' year-on-year growth of total customer deposits

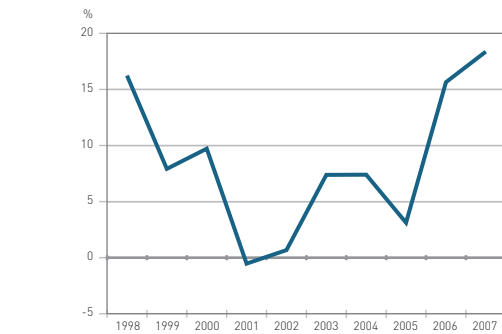
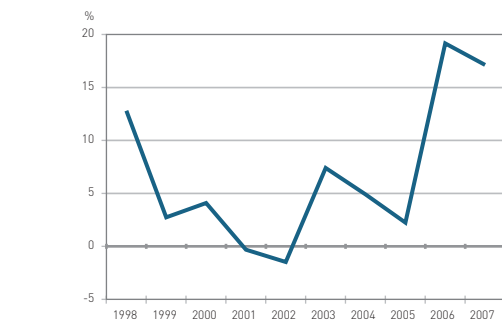
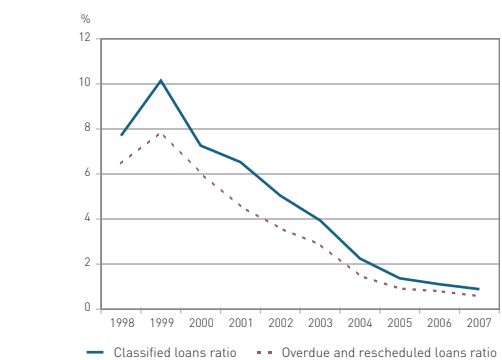


Chart 19. Retail banks' year-on-year growth of Hong Kong dollar deposits*



* Including swap deposits.

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



The quality of banks' residential mortgage portfolios remained solid, with the mortgage delinquency ratio declining to 0.11% and the rescheduled loan ratio to 0.20% (Chart 21). The quality of the mortgage portfolio was underpinned by rising property values and higher household incomes.

In line with the increase in property values, the outstanding number of residential mortgage loans in negative equity decreased by 78% to about 1,900 cases by the end of 2007 from about 8,400 at the end of 2006. Compared with the peak of about 106,000 cases in June 2003, the number of negative equity cases had fallen by 98%.

Corresponding to an increase in the number of bankruptcies in 2007, credit card receivables rescheduled during the year increased by 34% and the total charge-off amount grew by 6%. However, because of the strong growth in receivables, the credit card charge-off ratio

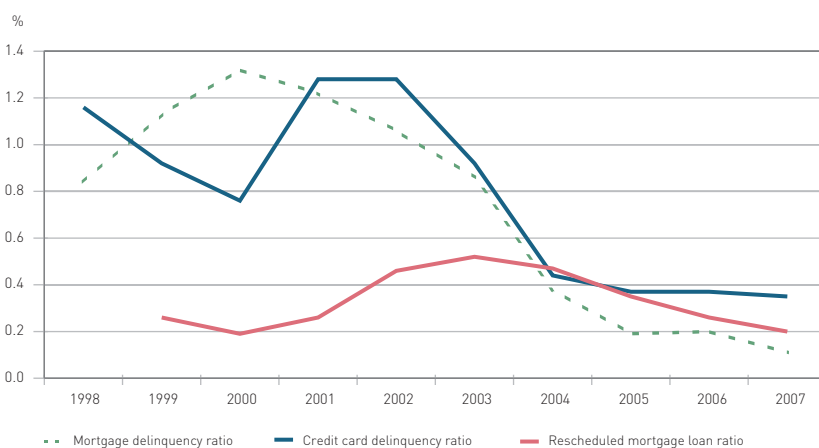
for the year was stable at 2.90% (Chart 13) and the delinquency ratio decreased to 0.35% from 0.37% at the end of 2006 (Chart 21). Together with the outstanding rescheduled credit card receivables, which remained stable at \$52 million (0.1% of total credit card receivables), the combined delinquent and rescheduled ratio declined further to 0.42% at the end of the year from 0.44% at the end of 2006.

The quality of the retail banks' investment in debt securities worsened in 2007 mainly due to the sub-prime turmoil. At the end of 2007, retail banks' investments in debt securities which were classified as "substandard", "doubtful" or "loss" represented about 0.05% of the banks' total assets, and investment under special mention was 0.09%. The majority of the special mention and classified investment was sub-prime related instruments.

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

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

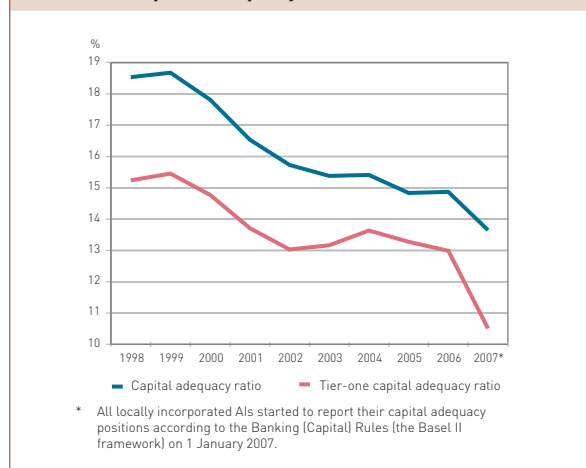
Chart 21. Quality of credit card receivables and mortgage lending of surveyed institutions



Strong capital ratio

Since January 2007 when Basel II was implemented in Hong Kong, all Hong Kong-incorporated AIs have been required to report their capital adequacy positions under the revised capital adequacy framework. Under the new system, which is more risk-sensitive than the previous framework, the average consolidated capital adequacy ratio of all locally incorporated AIs at the end of 2007 was 13.4% and the average tier-one capital ratio was 10.6% (Chart 22). The figures at the end of 2006 were 14.9%[†] and 13.0%[†] respectively. Parallel reporting under the two frameworks at the end of December 2006 indicated that the additional capital charge for operational risk was the main reason for the decline. Despite the apparent decline, the capital position of the banking industry remains strong and well above the international minimum of 8%.

Chart 22. Locally incorporated AI's consolidated capital adequacy ratio



PROSPECTS FOR 2008

Although the US sub-prime problem has had a major impact on the global financial system, the Hong Kong banking sector had little direct exposure. The strong financial and liquidity position of the banking sector also provides a substantial buffer against disturbances. The implementation of Basel II has also strengthened supervisory and risk-management practices, making the banking system more resilient. However, there may still be a longer-term impact, depending on developments in the US economy. Given this uncertainty in the operating environment of the banking sector, and with continued keen competition, there is a need for greater focus on liquidity management, more rigorous stress testing, monitoring of asset quality for signs of deterioration, and prudent valuation of structured products.

While deposits increased sharply in 2007 as a result of the buoyant stock market and heavy IPO-related activity, banks must manage their liquidity positions carefully in the light of liquidity events elsewhere. AIs also need to ensure that profits derived from residential mortgage business are commensurate with the risks involved and that underwriting standards remain prudent as competition in the market continues to be intense.

Although the high level of stock market activity has benefited the performance of the banking sector, banks have also become more exposed to the market's volatility, providing another source of uncertainty in 2008.

[†] 2006 figures revised.



Monetary Stability

Monetary conditions remained stable in 2007 despite domestic and external shocks, demonstrating the resilience of the Linked Exchange Rate system. Activities in Hong Kong's foreign exchange and money markets were generally orderly, although there was increased volatility in exchange rates and interest rates in the second half of 2007.

OBJECTIVES

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

The Monetary Base comprises (Table 1)

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

 > [Monetary Base](#)

Table 1. Monetary Base

\$ million	31 Dec 2007	31 Dec 2006
Certificates of Indebtedness ¹	163,435	157,385
Government-issued notes and coins in circulation ¹	7,547	6,862
Balance of the banking system	10,639	2,035
Exchange Fund Bills and Notes issued ²	138,369	132,113
TOTAL	319,990	298,395

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

² The amount of Exchange Fund Bills and Notes (EFBN) shown here is different from that in the balance sheet of the Exchange Fund in this Annual Report. In accordance with the accounting principles generally accepted in Hong Kong, the EFBN held by the HKMA on behalf of the Exchange Fund in relation to its trading of the EFBN in the secondary market are offset against the EFBN issued, and the net amount is recorded in the balance sheet. The EFBN issued on tender dates but not yet settled are included in the balance sheet but excluded from the Monetary Base.

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest-rate adjustment mechanism as well as the firm commitment to honour the Convertibility Undertakings (CUs) by the HKMA. When the demand for Hong Kong dollars is greater than supply and the market exchange rate strengthens to the strong-side CU of HK\$7.75 to the

US dollar, the HKMA stands ready to sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then expand to push down Hong Kong dollar interest rates, creating monetary conditions that move the Hong Kong dollar away from the strong-side limit to within the Convertibility Zone of 7.75 to 7.85. On the other hand, if the supply of Hong Kong dollars is greater than demand

Monetary Stability

and the market exchange rate weakens to the weak-side CU of HK\$7.85 to the US dollar, the HKMA will buy Hong Kong dollars from banks. The Aggregate Balance will then contract to drive Hong Kong dollar interest rates up, pushing the Hong Kong dollar away from the weak-side limit to stay within the Convertibility Zone.

[Home](#) > [Monetary Stability](#) > [Currency Board System](#)

REVIEW OF 2007

Monetary conditions remained stable in 2007 despite continued strengthening of the renminbi; a number of large initial public offerings (IPOs) in the equities market; increased volatility in global financial markets in the wake of the US sub-prime mortgage crisis; and large and unpredictable capital flows partly induced by the announcement of the pilot scheme for Mainland individuals to invest directly in the Hong Kong equity market (the so-called “through train” scheme) and the scheme’s subsequent delay. This underscored the resilience of the Linked Exchange Rate system in the face of domestic and external shocks.

Throughout 2007, activities in Hong Kong’s foreign exchange and money markets were generally orderly, although there was increased volatility in exchange rates and interest rates in the second half of the year. Under the present monetary arrangements, the CUs limit the fluctuations of the Hong Kong dollar exchange rate within a narrow band, and the Discount Window borrowing mechanism dampens volatility of domestic interest rates during shocks.

After staying close to the strong side of the Convertibility Zone in 2006, the Hong Kong dollar market exchange rate depreciated in the first seven months of 2007, reaching a peak of 7.8295 on 2 and 3 August (Chart 1). This partly reflected interest rate arbitrage taking advantage of the lower domestic interest rates relative to those of the US and the conversion of proceeds from IPOs into US dollars by Mainland companies newly listed in Hong Kong. When the renminbi strengthened beyond the Hong Kong dollar spot exchange rate in mid-January, there was little reaction in the foreign exchange market.¹ This suggests that the HKMA was successful in managing market expectations to address speculation that the Hong Kong dollar would follow the appreciation of the renminbi.

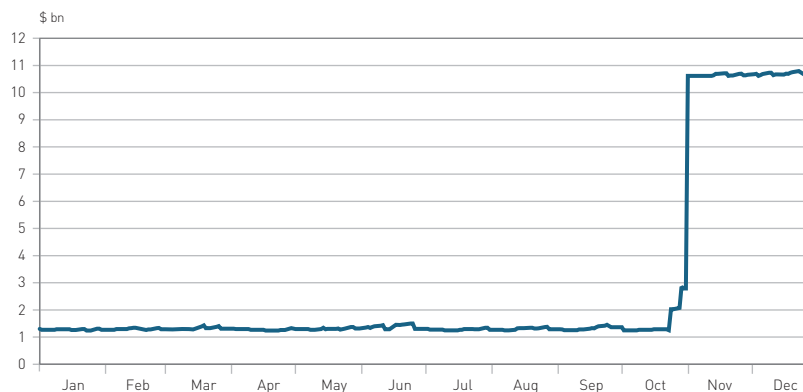


¹ The renminbi appreciated beyond 7.85 (entering the Convertibility Zone of the Hong Kong dollar) on 27 November 2006, breached 7.80 on 11 January 2007, surpassed the Hong Kong dollar on 15 January 2007, and appreciated beyond 7.75 (leaving the Convertibility Zone) on 16 February 2007.

From August to October, the Hong Kong dollar exchange rate quickly strengthened towards the strong-side CU of 7.75. The rise was due to several factors. In August the US sub-prime mortgage problems and the resulting increase in global risk aversion induced the unwinding of Hong Kong dollar-funded carry-trade positions. Later, equity-related demand for Hong Kong dollars increased substantially under the influence of a series of heavily subscribed IPOs between September and November. A buoyant stock market, which was partly boosted by the announcement of the “through train” scheme allowing Mainland residents to invest in the local stock market and the extension of the Qualified Domestic Institutional Investors scheme, also helped sustain equity-related demand for the Hong Kong dollar.

Following the strengthening of the Hong Kong dollar to near the strong-side CU, the HKMA operated within the Convertibility Zone on 23 October, for the second time since the introduction of the three refinements in 2005.² On that day, the Hong Kong dollar spot exchange rate once touched 7.75 although no banks approached the HKMA to activate the strong-side CU. Meanwhile, short-term Hong Kong dollar interest rates were firm and a forthcoming large IPO was expected to tighten the money market considerably. Taking into account the prevailing market conditions, the HKMA operated within the Convertibility Zone, selling Hong Kong dollars against US dollars. The Aggregate Balance increased by \$775 million on 25 October (Chart 2). This operation was consistent with the Currency Board principles because the increase in the Aggregate Balance, which is a component of the Monetary Base, was fully matched by an increase in the US dollar reserves.

Chart 2. Aggregate Balance, January-December 2007



² The first time the HKMA operated within the Convertibility Zone was on 25 May 2005, shortly after the introduction of the three refinements to the Linked Exchange Rate system. The HKMA sold HK\$554 million to banks on that date, catering to increased liquidity demand arising from a number of equity IPOs.

Monetary Stability

Licensed banks triggered the strong-side CU once on 26 October and five times on 31 October, prompting the HKMA to passively sell Hong Kong dollars against US dollars at HK\$7.75 to US\$1. The strong demand for Hong Kong dollars was supported by persistent equity-related inflows associated with a large IPO and the buoyant stock market. Rumours regarding possible changes to the peg also briefly boosted speculative demand for Hong Kong dollars. With the triggering of the strong-side CU, the Aggregate Balance increased by \$775 million on 30 October and \$7,828 million on 2 November. These market operations softened both the Hong Kong dollar exchange rate and interbank interest rates, normalising the relationship between a strong exchange rate and tight interbank interest rates observed previously.

In the last two months of 2007, the Hong Kong dollar exchange rate depreciated towards the centre of the Convertibility Zone due to carry trades in a low interbank interest rate environment. In the absence of further triggering of the CU, the Aggregate Balance closed at around \$10.6 billion at the end of 2007, after staying at \$1.3 billion for more than two years.

Movements in the Hong Kong dollar interbank interest rates largely tracked the equivalent US dollar rates, with occasional deviations due to sharp rises in funding demand arising from heavily subscribed IPOs. Part of the

volatility of US dollar interest rates between August and December was transmitted to local interbank interest rates, as shown by the increased standard deviation of daily changes in one-month interbank interest rates (relative to the annual average level) over the same period. However, banks and other financial institutions in Hong Kong are generally well capitalised and experienced in dealing with this situation.

Hong Kong dollar interbank interest rates generally increased between January and mid-September, first as a result of interest rate arbitrage activities, and then because of increased liquidity demand arising from concerns about the effect of the US sub-prime mortgage problem (Chart 3). There were temporary decreases in short-term Hong Kong Interbank Offered Rates (HIBORs) when the US Federal Reserve cut both the federal funds target rate and the discount rate by 50 basis points to 4.75% and 5.25% respectively on 18 September.

Short-term HIBORs rose shortly afterwards. The one-month and three-month HIBORs reached highs of 5.75% and 5.48% respectively on 12 October, underpinned by the increased funding demand associated with IPOs of Mainland companies. For a short period, the HIBORs were higher than the corresponding US dollar London Interbank Offered Rates (LIBORs), as the latter declined along with the easing US monetary policy. This resulted

Chart 3. HIBORs and LIBORs, January-December 2007



in a temporarily positive HIBOR-LIBOR differential in mid-October (Chart 4).

From mid-October, Hong Kong dollar interbank interest rates eased, gaining momentum when the supply of liquid funds in the interbank market increased because of the expansion in the Aggregate Balance after the triggering of the strong-side CU. The one-month and three-month HIBOR-LIBOR differentials also turned negative and widened. On 31 October, the US Federal Reserve reduced the federal funds target rate by another 25 basis points to 4.50%, further reinforcing the declines in HIBORs and LIBORs.

While overseas financial markets showed signs of improvement following the US Federal Reserve's actions in mid-September and late-October, the market situation and sentiment deteriorated significantly as major US financial institutions and some of their Structured Investment Vehicles reported multi-billion dollar write-offs for sub-prime-related debt securities and a large decline in quarterly profits. Continued bad news from the US finance industry increased uncertainties about the magnitude and impact of sub-prime-related losses and fuelled fears that losses would be much worse than anticipated, leading to a renewed bout of risk aversion and rising credit spreads in almost all asset classes.

Consequently, short-term LIBORs increased markedly and were well above the US federal funds target rate in November. Because of this external factor, coupled with higher domestic liquidity demand associated with IPO activities, domestic interbank interest rates also rose. However, there were no signs of spill-over from the US sub-prime mortgage crisis causing stress in the local credit markets. Discount Window borrowing activity remained normal, and the overnight interbank interest rate did not exceed the Base Rate.

On 11 December, the US Federal Reserve cut the federal funds target rate by another 25 basis points to 4.25% to address increased strains in financial markets and slowing economic growth associated with intensifying correction in the US housing market. On the following day, the US Federal Reserve, the Bank of England, the European Central Bank, the Bank of Canada, and the Swiss National Bank announced a joint effort to address elevated pressures in short-term funding markets by injecting term funds through a range of counterparties and against a broader range of collateral than that used for open market operations. The resulting decreases in short-term LIBORs were followed by a similar decline in short-term HIBORs and the negative HIBOR-LIBOR differentials of around 150 basis points persisted towards the end of 2007.

Chart 4. HK dollar – US dollar interest rate differentials, January-December 2007



Monetary Stability

Despite momentarily turning from discounts to small premiums in mid-October, the Hong Kong dollar forward points were generally negative, narrowing from January to mid-October but then widening (Chart 5). This was consistent with the movements in the interest rate differentials. The three-month and 12-month forward points closed at -260 and -660 pips respectively on 31 December.

To improve the transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October

1998. The Backing Ratio, defined as the Backing Assets over the Monetary Base, surpassed 112.5% (defined as the Upper Trigger Level) on 21 January and 6 August, reflecting interest income and revaluation gains (Chart 6). Under the arrangements approved by the Financial Secretary in 2000, a portion of the Backing Assets was then transferred to the Investment Portfolio, restoring the Backing Ratio to around 110% on 22 January and 7 August. Following the asset transfer in August, there were downward pressures on the Backing Ratio as the effect of interest income was offset by valuation losses, resulting from the strengthening of the Hong Kong dollar

Chart 5. Hong Kong dollar forward points, January–December 2007

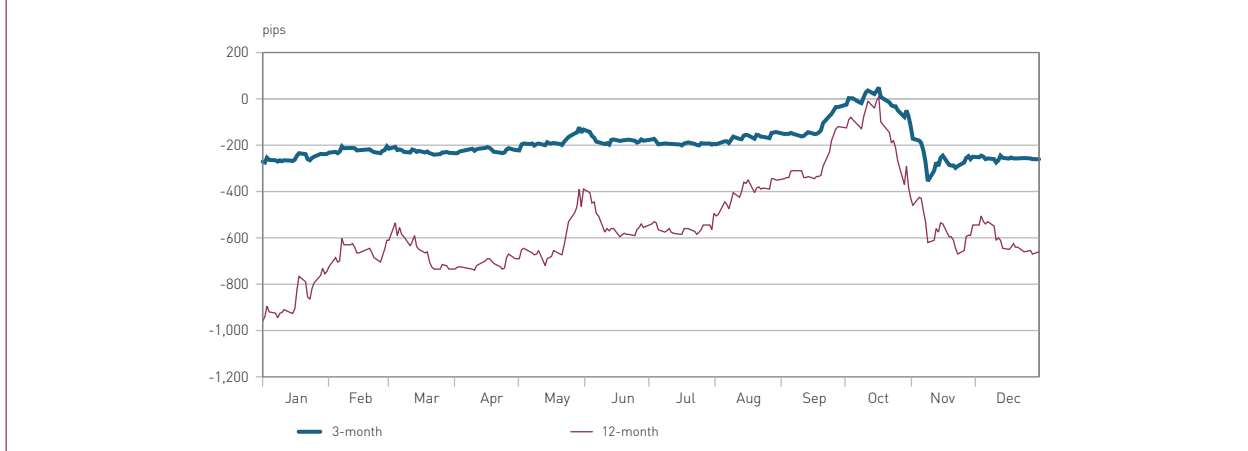
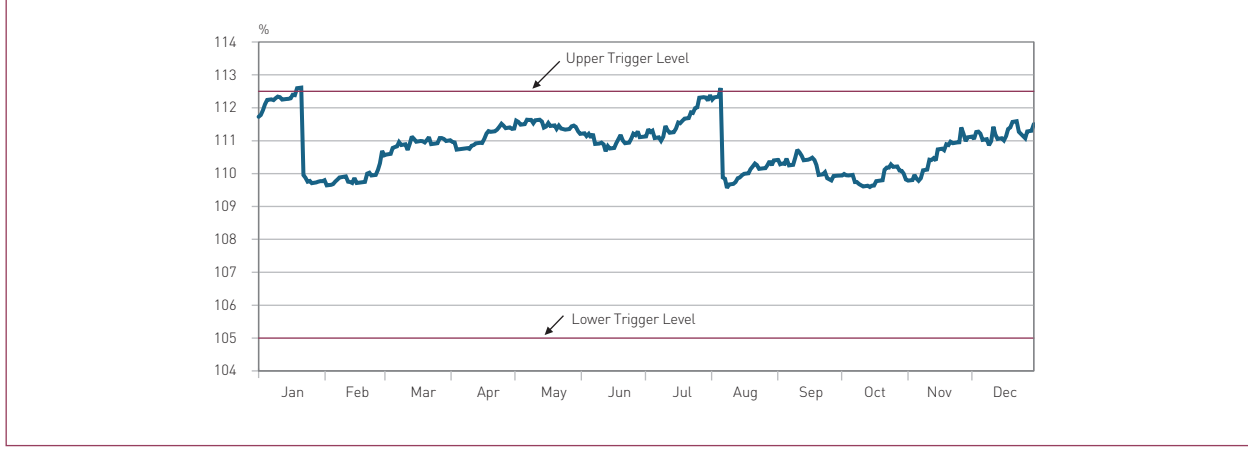


Chart 6. Daily movement of the Backing Ratio, January–December 2007



against the US dollar, and the subsequent expansion of the Aggregate Balance.³ In November and December, benefiting from revaluation gains associated with the weakening of the Hong Kong dollar against the US dollar and interest income, the Backing Ratio increased again and closed at 111.5% on 31 December.

Activities at the HKMA

The EFAC Currency Board Sub-Committee, established in August 1998, continued to monitor and review issues pertinent to monetary and financial stability in Hong Kong. Records of the Sub-Committee's meetings and the monthly reports on Currency Board operations submitted to the Sub-Committee are published on the website of the HKMA. In 2007, these issues included the best lending rate adjustment decisions of Hong Kong banks, Hong Kong's trade patterns and trade elasticities, the behaviour of the Hong Kong dollar exchange rate within the Convertibility Zone and the credibility of the Linked Exchange Rate system, sources of employment growth in Hong Kong, the significance of Mainland macroeconomic shocks in affecting Hong Kong's interest rates, the impact of the renminbi exchange rate on Asian currencies, the equilibrium real effective exchange rate of the Hong Kong dollar, and the development of an early warning system for banking distress.

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

The Hong Kong Institute for Monetary Research, established in August 1999, continued to sponsor research in the fields of monetary policy, banking and finance. In 2007, the Institute hosted 15 full-time and five part-time research fellows. It also published 24 working papers and one occasional paper, and jointly published a book entitled *Hong Kong's Link to the US Dollar* by John Greenwood with the Hong Kong University Press.

The Institute co-organised two international conferences. The first, held in April with the Centre of Asian Studies of the Hong Kong University, reviewed the monetary and banking history of Hong Kong. The second, held in July with the Hong Kong University of Science and Technology, looked at the issues of monetary policy and monetary transmission mechanisms in open economies. In October, the Institute organised jointly with the Wang Yanan Institute for Studies in Economics of the Xiamen University a two-day workshop entitled "Analysing, Modelling and Forecasting Macroeconomic Fluctuations in Mainland China". Other programmes included a joint three-day workshop in May with the Bank of England's Centre for Central Banking Studies on advanced economic modelling and forecasting, with participants from seven central banks in the region, and the Fifth Summer Workshop in August. In addition to conferences and workshops, 52 public seminars were organised during the year on a broad range of economic and monetary issues.

 > [Research](#)

PLANS FOR 2008 AND BEYOND

The global economy is facing a high degree of uncertainty. The HKMA will continue to monitor risks and vulnerabilities in the domestic and external environment. The EFAC Currency Board Sub-Committee will examine issues relevant to Hong Kong's monetary and financial stability, review the technical aspects of the Currency Board arrangements and, where appropriate, recommend measures to strengthen them. Examples include the increase in the supply of Exchange Fund paper to meet the strong demand for settlements alongside the increase in equity market transactions, and the strengthening of the efficiency of Hong Kong's payment systems to handle large and volatile payment flows.

³ The expansion in the Aggregate Balance exerted a downward influence on the Backing Ratio because while the Backing Assets rose by the same magnitude as the Monetary Base (as required under the Currency Board arrangements), the proportional increase was smaller in the former due to its larger size.



Banking Stability

In 2007 Hong Kong became one of the first jurisdictions to implement Basel II, the new international standard for capital and risk management. Approval for the adoption of the Internal Ratings-based approach was granted to four authorized institutions. The HKMA also continued to improve its banking supervisory approach through the wider use of thematic reviews to promote good risk management and internal control practices in various areas of business. Particular attention was also paid to assessing the impact of the US sub-prime mortgage crisis on individual authorized institutions and the banking sector as a whole. The Deposit Protection Scheme marked the first anniversary of its operation on 25 September 2007.

OBJECTIVES

Promoting the safety and stability of the banking system through the regulation of banking and deposit-taking businesses and the supervision of authorized institutions (AIs)¹ is a primary function of the HKMA. The responsibility is shared among three departments:

- the Banking Supervision Department handles the day-to-day supervision of AIs
- the Banking Policy Department formulates supervisory policies to promote the safety and soundness of the banking sector
- the Banking Development Department formulates policies to promote the development of the banking industry.

requiring guidance to be issued to assist AIs to improve the effectiveness of their risk management and control practices.

A total of 246 on-site examinations were performed in 2007. Nearly half (106) were thematic examinations on a range of business activities of AIs, including assessing their compliance with the business restrictions on renminbi business and the Qualified Domestic Institutional Investors (QDII) scheme; retail wealth management activities; control over registration of relevant individuals (ReI) for securities business; operational risk management; IT problems and system change management; and 24 examinations on AIs' anti-money-laundering (AML) and counter-terrorist-financing (CFT) controls over customer due diligence, on-going transaction monitoring and remittance transactions.

REVIEW OF 2007

Risk-based supervision

More resources were devoted to conducting thematic examinations of AIs covering selected lines of business and major risk areas during the year. The aim was to enable the HKMA to promote good risk management and internal control practices and to identify specific issues



Deputy Chief Executive Y K Choi (second from left) and the three Executive Directors in charge of banking matters at the annual press conference "Hong Kong Banking Sector: 2007 End-Year Review and Prospect and Priorities for 2008".

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

Banking Stability

The HKMA conducted 86 risk-based and nine overseas examinations, including reviews of certain Als' operations in Mainland China. Specialist teams also carried out detailed examinations of risk management controls in specific areas, including Als' treasury and derivatives activities, business continuity planning, e-banking activities and technology risk management and practice; and tier-2² examinations of the securities business of Als and their procedures to combat money laundering and terrorist financing.

The HKMA performed specialised reviews on the qualitative, quantitative and IT system aspects of internal rating systems to assess the readiness of Als intending to implement either the foundation or advanced Internal Ratings-based (IRB) approach for credit risk under Basel II in 2007 or 2008 [see separate box on Basel II implementation for details].

In addition to on-site examinations, 193 off-site reviews were conducted and 39 tripartite meetings³ held. Other duties included the approval of acquisitions of local Als and handling of non-compliance with guidelines or statutory requirements. The supervisory teams met the boards of four banks and members of board-level committees, in particular the audit committees, of 13 other banks and one restricted licence bank.

The Banking Supervision Review Committee considered 10 cases relating to the licensing of Als and money brokers and two cases concerning possible contraventions of the Banking Ordinance by Als. In addition, 296 applications to become controllers, directors, chief executives and alternate chief executives of Als were approved. Details of the operational supervisory work performed in 2007 are set out in Table 1.

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

³ An annual meeting between the HKMA and an AI and its auditors.

Table 1. Operational supervision

	2006	2007
1. On-site examinations	247	246
<i>Regular examinations</i>	96	95
– risk-based	86	86
– overseas	10	9
<i>Basel II – IRB validation</i>		15
– qualitative	–	5
– quantitative	–	5
– IT aspects	–	5
<i>Specialised examinations</i>	40	30
– treasury and derivatives activities	9	10
– securities (tier-2)	7	7
– business continuity plan	15	5
– e-banking activities and technology risk management	5	5
– AML/CFT controls (tier-2)	4	3
<i>Thematic examinations</i>	111	106
– renminbi banking business	25	22
– QDII scheme	–	7
– retail wealth management	22	18
– relevant individuals registration controls for securities business	–	11
– IT problems and system change management	–	13
– operational risk management	–	11
– AML/CFT controls over correspondent banking and private banking	22	–
– AML/CFT customer due diligence	–	8
– AML/CFT on-going transaction monitoring	–	6
– AML/CFT implementation of FATF special recommendation VII in remittance transactions	–	10
– controls for protecting customer data	15	–
– implementation of Standardised (credit risk) approach and the IRB approach under Basel II	17	–
– investment advisory activities	10	–
2. Off-site reviews and prudential interviews	185	193
3. Tripartite meetings	51	39
4. Meetings with boards of directors or board-level committees of Als	21	18
5. Approval of applications to become controllers, directors, chief executives, alternate chief executives of Als	278	296
6. Reports commissioned under Section 59(2) of the Banking Ordinance	1	3
7. Cases considered by the Banking Supervision Review Committee	15	12

The Monetary Authority used his powers under Section 59(2) of the Banking Ordinance to require three AIs to commission external auditors to review, respectively, their operational controls, AML controls and liquidity management and to report their findings to the HKMA. Another two AIs voluntarily appointed external auditors to review their controls on selected areas identified by the HKMA. Improvements were subsequently implemented.

During 2007, no AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio (CAR). One locally incorporated deposit-taking company and one foreign bank branch were found to have breached the liquidity ratio requirement for a short period because of technical errors. However, the breaches were rectified promptly once the problems were discovered. They did not pose any threat to the safety and soundness of the institutions or to the interests of depositors. There was one breach of the requirements under Section 81 relating to large exposures, one under Section 83 on connected lending, one under Section 85 on lending to AI's employees, and one under Section 87 relating to the shareholding by an AI. These breaches were assessed to be unintentional. They were rectified promptly by the AIs and did not affect the interests of depositors.

Powers under Section 52 of the Banking Ordinance

The appointment of a Manager, on 16 September 2005, under Section 52(1)(C) of the Banking Ordinance to manage the affairs, business and property of Delta Asia Credit Limited (DAC), a deposit-taking company, remained in effect during 2007. The HKMA continued to communicate closely with the relevant authorities to monitor developments related to DAC and its parent bank in Macau, and to review regularly the supervisory measures to safeguard the interests of DAC's depositors and the integrity of the banking system. During the year, the Monetary Authority also appointed an Advisor under Section 52(1)(B) of the Banking Ordinance to advise the management of Octopus Cards Limited (OCL), among other things, on matters relating to protection of cardholders' interests.

CAMEL⁴ rating review

Following the implementation of the supervisory review process (SRP) for locally incorporated AIs under Pillar 2 of Basel II in January 2007, the HKMA reviewed the CAMEL rating process to ensure consistency of assessment standards and to minimise any duplication between the two. To make the CAMEL rating scale for local AIs more detailed, the 5-grade system has been expanded to 13 grades to improve its risk differentiation. The 5-grade CAMEL scale will continue to apply to foreign AIs.

During the year, the CAMEL Approval Committee met 17 times to determine the ratings of individual AIs. One bank requested a review of its ratings and a meeting of the CAMEL Approval Review Committee, formed by members not involved in the original rating decision, was convened to consider the request.

The CAMEL ratings of licensed banks on 20 October 2007 were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board for the purpose of determining the contributions to be paid by the banks in 2008 under the Deposit Protection Scheme.

Specialised supervisory work

Supervision of technology and operational risks

Internet banking, technology risk and business continuity management

The utilisation of Internet banking services continued to show healthy growth following the launch of two-factor authentication in 2005. There were 4.9 million personal and 307,000 business Internet banking accounts at the end of 2007 (compared with 3.8 million and 234,000 respectively in 2006). Thirty-two AIs have implemented the two-factor authentication mechanism. The HKMA worked with the Hong Kong Association of Banks and the Hong Kong Police Force to launch, in April 2007, a new

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

educational leaflet *Internet Banking – Convenient & Safe* to provide up-to-date security tips on Internet banking for the public.

In view of the upsurge in equity market transactions since mid-2007, the HKMA has strengthened its supervisory efforts, particularly in monitoring the utilisation of the on-line securities trading systems of major AIs. A circular was issued to AIs offering retail Internet banking services, reminding them to ensure their on-line securities trading systems could cope with anticipated business growth. Where system-capacity issues were identified, the HKMA required the AIs concerned to strengthen their systems. Of the 12 AIs involved, most had adequately expanded their system capacities before the end of 2007. The remaining AIs were expected to complete system upgrading by April 2008.

The annual self-assessments of technology risk management by AIs indicated that there should be an increased focus on controls over IT problems and system change management. The HKMA conducted thematic examinations of 13 AIs and found room for improvement in certain aspects of controls over IT incident management and the implementation of emergency changes to IT systems. A circular was issued to all AIs to share with the banking industry the common issues identified and the good practices adopted by some of the AIs examined.

As part of its continued upgrading of its supervisory efforts, the HKMA has extended the coverage of the automated control self-assessment process for technology risk management, Internet banking and business continuity management to 61 AIs. The self-assessment results indicate a significant improvement in the overall IT controls of AIs since the process was launched in 2003.

The HKMA continues to participate in the International Information Technology Supervisors' Conference to share experience and knowledge with overseas banking supervisors on Internet banking and technology risks, particularly emerging fraudulent techniques.

Operational risk management

A specialist team was established to develop a supervisory framework for assessing the adequacy and effectiveness of AIs' operational risk management due to the growing importance of this issue. A profiling system was devised to assist on-going assessments and monitoring of these risks. A structured process was also established to support the review of applications from AIs wanting to adopt the Standardised Approach (STO) or Alternative Standardised Approach (ASA) for operational risk calculation under the Basel II framework, in line with the practices of leading overseas regulators. A pilot scheme was conducted in the fourth quarter of 2007. In addition, validation examinations were conducted for the STO or ASA applications of 10 AIs.

Supervision of securities and insurance businesses

The HKMA co-operates closely with the Securities and Futures Commission (SFC) on matters of common supervisory interest. The two regulators communicate regularly to discuss supervision of the securities business of registered institutions (RIs)⁵. The HKMA also worked with the SFC and industry practitioners to devise a new measure to prevent multiple applications for initial public offerings. A circular was issued in March 2007 drawing the attention of AIs to the new measure as well as recommended practices to identify and reject multiple applications.

⁵ A registered institution is an AI which is registered under the Securities and Futures Ordinance to conduct securities intermediary activities.

Circulars were issued in 2007 to highlight the major issues and good practices identified in the joint HKMA and SFC thematic examinations on investment advisory activities completed in the second half of 2006. RIs were recommended to establish controls and procedures to ensure compliance with the regulatory standards set out in the SFC's report of the examination findings.

One of the key focuses of the securities supervisory regime in 2007 was to ensure that RIs engage only fit and proper individuals, with appropriate registration, to conduct securities business. Thematic examinations conducted by the HKMA in 2007 showed that the controls of most of the examined RIs were effective, although some were advised to strengthen their procedures for performing background checks. A circular was also issued in June recommending RIs to prevent unregistered dealings by implementing adequate procedures.

In 2007 the HKMA processed 11 applications for registration to become RIs and five applications from RIs to engage in additional regulated activities. It also granted consent to 151 executive officers, who are responsible for supervising the securities activities of RIs; and conducted background checks on 5,541 individuals whose information was submitted by RIs for registration.

The number of RIs participating in the automated control self-assessment on securities activities increased to 45. There has been continued improvement in the self-assessment results since the process was launched in 2005.

A meeting was held between the HKMA and the Insurance Authority in October 2007 to discuss current and evolving supervisory issues. The two authorities agreed on ways to improve communication in relation to the supervision of Als' insurance activities. Day-to-day co-operation continued on the handling of insurance-related complaints under mutually agreed procedures.

Supervision of treasury activities

During 2007, the HKMA conducted 10 treasury examinations, focusing on Als' risk management processes and internal controls over the risks arising from their treasury and derivatives activities. The results of these examinations indicated that Als generally have adequate and effective risk management frameworks and internal controls for these activities. Regular meetings were held with Als' heads of treasury operations to understand any emerging risks the Als encountered and how they managed those risks. In particular, the HKMA continued to monitor the impact of the US sub-prime crisis on Hong Kong's banking industry.

China-related businesses

Renminbi banking business

At the end of 2007, 38 licensed banks were eligible to conduct renminbi banking business. The total amount of renminbi deposits reached RMB33.4 billion, representing a 42.7% increase from a year earlier. With the State Council's approval earlier in the year, qualified Mainland financial institutions were allowed to issue renminbi bonds in Hong Kong and Participating Banks in renminbi business were allowed to provide the associated services from June 2007. These include opening deposit accounts for renminbi bond issuers and underwriters, remitting renminbi bond proceeds to Mainland China, providing a one-way exchange service (from renminbi to Hong Kong dollars) for renminbi bond issuers to settle expenses incurred in bond issuance, and trading renminbi bonds for proprietary and customer accounts. The expanded scope of renminbi banking business allows renminbi deposit account holders in Hong Kong to invest directly in renminbi bonds, and provides an opportunity for Participating Banks to diversify their renminbi asset portfolio.

The HKMA monitored the renminbi business conducted by the Participating Banks, set out the supervisory requirements regarding the expanded scope of renminbi business, and revised the related prudential returns to facilitate supervision and surveillance. While the results of earlier examinations indicated that Participating Banks' internal controls were generally effective and in line with regulatory requirements, the HKMA issued a circular in March 2007 to remind them of compliance issues that needed further improvement.

Relaxation of overseas investments by Mainland residents

In the second quarter of 2007, the China Banking Regulatory Commission (CBRC) expanded the scope of overseas wealth management services that can be provided by commercial banks operating on the Mainland under the QDII scheme. Subject to specific conditions, qualified commercial banks can invest on behalf of customers in equities and related products in an overseas market where the regulator has signed a Memorandum of Understanding with the CBRC. Hong Kong became the first such market. At the end of 2007, the Mainland subsidiaries of six banks incorporated in Hong Kong had been given approval to provide the overseas wealth management services. Late in the year, the HKMA conducted a round of thematic examinations of seven banks whose Hong Kong offices were performing functions in support of the overseas wealth management services provided by Mainland banks. By early 2008, the results were being reviewed and major issues found will be shared with the industry.

The joint working group formed by the CBRC, the State Administration of Foreign Exchange, the HKMA and the SFC met during the year to discuss ways to further improve the scheme as well as the development of training programmes on retail wealth management for Mainland practitioners. The working group provided support to the China Banking Association and the Hong Kong Institute of Bankers in conducting a two-day seminar on wealth management in Beijing in June with the emphasis on institutional risk management

and sales practices of frontline staff. Similar training programmes are expected to be arranged in the future.

Tapping the Mainland market

From December 2006, foreign banks, including those incorporated in Hong Kong, can conduct a full range of retail banking business on the Mainland by converting their Mainland branches into domestically incorporated banks. At the end of 2007, five Hong Kong-incorporated banks had restructured their Mainland branches to Mainland-incorporated subsidiary banks with a total of over 130 branches and sub-branches. With the increased presence of Hong Kong banks on the Mainland, the HKMA continued to monitor their business strategies and maintained regular contact with the CBRC to improve cross-border supervisory co-operation and co-ordination.

The HKMA also maintained close surveillance of Als' non-bank China exposures. Following expansion of the scope of prudential reporting in September 2006, the HKMA made further revisions in December 2007 to capture credit exposures booked in the Mainland banking subsidiaries of Hong Kong-incorporated banks. At the end of 2007, the industry's aggregate on-balance sheet non-bank China exposures amounted to \$592.2 billion or 5.2% of total assets.

Hong Kong-incorporated banks have gained greater access to the Mainland market since the implementation of the Closer Economic Partnership Arrangement (CEPA) in January 2004. By the end of 2007, five local banks that had benefited under CEPA had established nine branches or sub-branches on the Mainland. The latest improvements to CEPA, which became effective from January 2008, relax the criteria for Hong Kong-incorporated banks to gain the status of Hong Kong Service Supplier (a prerequisite for an entity to enjoy the benefits under CEPA) and to acquire shareholdings in Mainland banks. The Mainland authorities will also expedite the processing of Hong Kong banks' applications to establish branches in specific regions on the Mainland, including Guangdong Province.

Octopus Cards Advisor appointed

In February 2007, a number of incidents came to light of Octopus cardholders being unable to add value to their cards through the Easy Pay System (EPS) channel despite the funds being deducted from their bank accounts.

To ensure that the interests of cardholders were adequately protected, on 16 February 2007 the Monetary Authority served notice on OCL under Section 59(2) of the Banking Ordinance, requiring the company to submit an independent auditor's report on the operation of add-value services through EPS and OCL's operational risk control. After consultation with the Financial Secretary, the Monetary Authority also appointed an Advisor under Section 52(1)(B) of the Banking Ordinance to advise the management of OCL on matters relating to the protection of cardholders' interests and recommendations arising from the independent auditor's report.

The HKMA also requested OCL to review all its available records to identify whether there were other failed Octopus EPS add-value transactions and to make refunds to affected cardholders. As a result, in addition to the 571 failed Octopus EPS add-value transactions between 5 December 2006 and 3 February 2007, OCL identified approximately 15,300 potential affected transactions, which happened between 1 January 2000 and early-December 2006, involving approximately \$3.7 million. OCL started making refunds for these transactions in August 2007 and over 98% of them had been refunded by the end of the year.

The investigation of the independent auditor revealed that the failed Octopus EPS add-value transactions were mainly caused by design issues in some components of the add-value process, but these were not expected to pose systemic risk to other add-value channels or other parts of OCL's operations. The independent auditor has made a number of recommendations to improve OCL's operational risk management and the HKMA will monitor their implementation.

Credit risk management and asset quality

Despite the overall improvement in asset quality among AIs over the past few years, the HKMA was concerned about whether the continuing intense market competition in 2007 had resulted in any undue relaxation in underwriting criteria in the banking industry. During the year, supervisory resources were devoted to reviewing this area, particularly the level of exceptional credit approvals granted by individual AIs in areas such as debt-servicing ratios in residential mortgage lending, and taxi loan financing. While there was no clear trend of relaxation in underwriting criteria, the HKMA required some AIs to implement more stringent controls over exceptional credit approvals.

Co-operation with overseas supervisors

The exposure of banks around the world to emerging risks and the increased globalisation of banking activities have heightened the need for supervisors to co-operate more closely, both geographically and functionally. To enhance the exchange of supervisory information and co-operation, the HKMA has entered into Memoranda of Understanding or other formal arrangements with a number of overseas banking supervisory authorities. In 2007, Statements of Co-operation were signed with the Bank of Thailand, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision in the US, and a Memorandum of Understanding with the Bangko Sentral ng Pilipinas.

Meetings to discuss supervisory issues of common interest were also held during the year in Hong Kong and abroad with banking supervisory authorities from the Mainland, Macau, Indonesia, Japan, Malaysia, the Netherlands, Pakistan, the Philippines, Singapore, South Korea, Switzerland, Taiwan, Thailand, the UK, the US and Vietnam.

Risks posed by the sub-prime crisis

Impact on the Hong Kong banking sector

The HKMA began closely monitoring individual AIs' exposures to US sub-prime mortgages in mid-2007. The Authority also stress-tested the financial positions of local banks that reported sub-prime or related exposures. The stress-testing results indicate that the banks' capital positions are resilient to even a severe spill-over of the impact of the sub-prime crisis.

Based on the information submitted by AIs, the aggregate exposures of the Hong Kong banking sector to the US sub-prime or sub-prime-related instruments, including exposures to Structured Investment Vehicles, are not significant relative to the sector's total assets and do not pose any systemic risk to the banking sector. While the profitability of individual AIs with larger exposures could be more affected, this would not affect the safety and soundness

of these AIs given their relatively well-capitalised and highly liquid positions. The HKMA will continue to monitor the situation and hold discussions with the management of AIs to ensure they manage their sub-prime-related exposures effectively and prudently.

Latest developments and impact on interbank liquidity

For foreign banks operating in Hong Kong, the tightening effect of the sub-prime fallout on the interbank market since August 2007 has been small. In general, the Hong Kong dollar interbank market continued to function normally and foreign banks did not encounter much difficulty in obtaining funds to meet their usual liquidity requirements, particularly in borrowing shorter-maturity funds.

Basel II implementation

The Banking (Capital) Rules and the Banking (Disclosure) Rules came into effect on 1 January 2007, making Hong Kong one of the first jurisdictions to implement Basel II. These Rules prescribe how the CARs of Hong Kong-incorporated AIs are to be calculated and what information on the state of affairs, profit and loss, and CAR is to be publicly disclosed by them, in line with the recommendations under Pillars 1 and 3 of the Basel II framework.

Capital impact under the revised framework

AIs reported their CAR calculations under the Banking (Capital) Rules starting from their positions at the end of March 2007. The reported figures confirmed that the capital position of the banking sector continued to be strong under the revised framework, despite a slight drop in the average CAR mainly because of

the additional operational risk capital charge. On an individual AI level, the CARs reported by AIs were all above their statutory minimum ratios.

During the year, a number of AIs that had applied to adopt the IRB approach submitted their "parallel run" figures to the HKMA to demonstrate the robustness of their internal rating systems. These figures consisted of two sets of CAR calculations, one based on the approach they were currently using to calculate credit risk, and the other on the IRB approach. The submissions indicated that most of the AIs would be able to achieve capital savings with the use of the IRB approach.

Supplementary guidance on revised framework

To assist AIs in complying with the Banking (Capital) Rules, the HKMA issued supplementary guidance in a structured question-and-answer form, focusing on the more advanced approaches set out in the Capital Rules in relation to credit and market risks. Similarly, for the Banking (Disclosure) Rules, the HKMA issued a Supervisory Policy Manual (SPM) module "Guideline on the Application of the Banking (Disclosure) Rules" and a set of questions and answers to provide further guidance on how certain provisions of the Disclosure Rules should be applied.

In addition, the HKMA released in September an SPM module on the "Overview of Capital Adequacy Regime for Locally Incorporated Authorized Institutions". Setting out the legal basis and the key aspects of the revised capital adequacy framework, the module is a one-stop reference for AIs and other interested parties.

Supervisory review process under Pillar 2

The new assessment framework developed for the SRP has been implemented since 1 January 2007. The SRP, which is conducted as part of the risk-based supervisory process, has improved the HKMA's ability to evaluate and monitor individual AIs' capital adequacy and to determine their minimum CAR under the Banking Ordinance. The process takes into account their overall risk profile, including their risk management systems, and the extent of their exposure to residual risks not covered under the Banking (Capital) Rules, and their approach to conducting internal capital adequacy assessments. The SRP also facilitates the setting of supervisory priorities for individual AIs and allows the identification of key banking risks, or changes in those risks over time, within the banking sector.

During the year, the HKMA completed the first round of the SRP on Hong Kong-incorporated AIs using the new assessment framework. The SRP Approval

Committee, comprising senior members of the Banking Supervision and Banking Policy Departments, reviewed the assessment results of individual AIs to determine their minimum CAR and other supervisory issues requiring attention. AIs were notified of the results and were given the opportunity to request a review of their minimum ratios although no AIs did so in 2007. The HKMA will continue to upgrade the framework by identifying areas where refinements can be made.

Capital adequacy assessment process (CAAP)

A major objective of the SRP assessment framework is to provide the impetus for AIs to adopt better capital planning and management practices. This is achieved by requiring AIs to have an internal process for assessing their overall capital adequacy commensurate with the risk profile of their operations and a strategy for maintaining such capital levels. This internal process is commonly referred to as the CAAP. Given that many AIs are still in the early stages of developing their CAAP capabilities, the HKMA has not required AIs to have a well-developed CAAP, but expects them to have a concrete plan to adopt a CAAP that meets supervisory standards. In 2007, most AIs were still developing or upgrading their CAAPs with the HKMA monitoring their progress, requiring them to submit regular reports, and reviewing their documentation, including policy and project plans.

Assessment of AIs' readiness for the IRB approach

The HKMA has completed the assessment of applications from AIs planning to adopt either the foundation or advanced IRB approach for credit risk in 2007 or 2008. During the year, approvals were given to four AIs to adopt their chosen IRB approach for regulatory capital reporting purposes from the end of December 2007 or January 2008. The decisions were made based on the results of on-site examinations covering the quantitative and qualitative aspects of the internal rating systems, the relevant supporting

IT systems, data infrastructure, and the regulatory capital reporting platform adopted by these AIs for their compliance with the relevant requirements set out in the Banking (Capital) Rules.

Home/host co-operation

In arriving at the IRB approval decisions for the subsidiaries of foreign banking groups planning to adopt the IRB approach in Hong Kong, the HKMA, as host supervisor, has considered the assessments made by their home supervisors. In particular, the HKMA has relied on the home supervisors' reviews of the group-developed internal rating systems that are used by the subsidiaries in Hong Kong mainly for non-retail exposures. This was done to avoid supervisory overlap and reduce the regulatory burden on banks. To facilitate home and host co-operation, the HKMA participated in supervisory meetings and model review visits organised by the home supervisors for selected individual foreign banking groups. The two-way contact enables each party to stay informed about the IRB approval progress of individual banking groups, and to discuss issues of mutual interest identified by the reviews.

Counterparty credit risk

In line with its plan for Basel II implementation, the HKMA conducted a study in 2007 to determine its strategy for implementing the more advanced approaches to calculate counterparty credit risk (CCR)⁶. A survey of 15 selected AIs showed that most did not have immediate plans to use the advanced CCR approaches, and there was scope for improving their CCR management practices to align with the standards required under those approaches. As a result, the HKMA decided that priority should be given to promoting sound practices of CCR management within the banking sector through developing a supervisory guideline on CCR management in 2008, before finalising a strategy for implementing the advanced CCR approaches.

 > Basel II

⁶ CCR is the risk that the counterparty to a transaction may default before the final settlement of the transaction's cash flows. It creates a bilateral risk of loss to either counterparty to the transaction with uncertain market values that can vary over time with the movement of underlying market factors.

Improving the supervisory framework

Management of strategic and reputation risks

Strategic and reputation risks are two of the eight major types of inherent risk⁷ identified by the HKMA to be assessed under its risk-based supervisory process. AIs' ability to manage these risks reflects fundamentally the quality and competence of their management, and is crucial to maintaining a successful and sustainable business, especially in view of rapid changes in the business environment in which they operate. The HKMA has developed two new SPM modules on "Strategic Risk Management" and "Reputation Risk Management" to strengthen its approach to supervising these risks and

provide more guidance to AIs on how these risks should be managed. The former was issued as a guidance note in December after industry consultation, while the latter will undergo industry consultation in early 2008.

Stress-testing

The HKMA has regularly conducted supervisory stress tests on selected AIs to assess the resilience of the banking sector to risks and vulnerabilities within the financial system. In order to make the stress-testing programme more forward-looking and align its results more closely with changes in economic conditions, the HKMA has strengthened the programme by making use of macroeconomic credit risk models to estimate

⁷ The other six inherent risks are credit, market, interest rate, liquidity, operational and legal risks.

credit losses based on economic indicators such as GDP, property prices and interest rates. Because of the increasing volatility of the stock market and market events arising from the US sub-prime crisis, the HKMA has also incorporated additional stress scenarios to assess the possible impact of stock market corrections and Als' direct and indirect exposures to the US sub-prime market on their profitability and capital positions. The stress-testing results showed that despite the severity of the stress scenarios, the banking sector would be able to withstand the stress, although the financial impact on some Als might be more significant.

Prevention of money laundering and terrorist financing

The effectiveness of the supervisory function of the HKMA in combating money laundering and terrorist financing was strengthened in January with the centralisation of its policy and specialised examination teams into one division. In the second half of 2007, additional resources were provided to the specialised examination teams, which conducted 27 examinations during the year, including three rounds of thematic examinations focusing on customer due diligence for high-risk customers, on-going transaction monitoring and the implementation of Financial Action Task Force (FATF) on Money Laundering Special Recommendation VII on wire transfers.

Established in 2006 under the co-ordination of the HKMA, the Industry Working Group on Prevention of Money Laundering and Terrorist Financing provided a useful forum for the industry to exchange views on topical issues. The Group initiated three guidance papers in 2007. The first provides Als with guidance on how to handle relationships with politically exposed persons and was issued in November. Two further guidance papers on the customer due diligence process for offshore companies and proof of address for personal customers were in the final stages of industry consultation at the end of the year.

A major task of the HKMA during the year was to assist the Government in the joint mutual evaluation of Hong Kong by the FATF and the Asia/Pacific Group on Money

Laundering (APG). A mutual evaluation questionnaire detailing the AML and CFT regime in Hong Kong was submitted to both organisations in April. In November, a team of seven assessors undertook an on-site visit to Hong Kong for two weeks. They met numerous public and private sector organisations, including the Narcotics Division of the Security Bureau (which co-ordinates measures to prevent money laundering and terrorist financing in Hong Kong), the Financial Services and Treasury Bureau, the Department of Justice, law enforcement agencies, financial regulators and various industry bodies. The assessors also interviewed several financial institutions to gauge the effectiveness of Hong Kong's preventative framework. The mutual evaluation report on Hong Kong will be discussed and endorsed by the FATF and APG plenary sessions scheduled for June and July 2008 respectively.

While completing the mutual evaluation questionnaire, the HKMA identified several areas in its guidelines which required amendments in the wake of recent developments including the conclusion of the exercise on Non-co-operative Countries and Territories by the FATF. These minor changes were incorporated into the HKMA's guidelines in November, and a six-month grace period was given to Als to implement the revised requirements.

International co-operation

The HKMA participates in various international and regional forums for banking supervisors. These include the Basel Committee on Banking Supervision's International Liaison Group, Policy Development Group and various sub-groups, the EMEAP Working Group on Banking Supervision (WGBS), which the HKMA chairs, and the South East Asia, New Zealand and Australia Forum of Banking Supervisors.

As a member of the Basel Committee Accord Implementation Group's Validation Sub-group (AIGV), the HKMA participated in its regular meetings to exchange views on IRB system-related validation issues with other leading supervisors. In October, the HKMA hosted a regular meeting of the AIGV for the first time in Hong

Banking Stability

Kong. Following the meeting, the Basel Committee, the Financial Stability Institute, and the EMEAP WGBS jointly organised a regional outreach event in Hong Kong on Basel II implementation in Asia focusing on the IRB approach.

Following the implementation of Basel II, the Basel Committee created two new policy sub-groups in 2007 to review the definition of regulatory capital across jurisdictions in the light of market developments on capital instruments and to analyse national liquidity regimes given the changing nature of liquidity risk due to rapid financial market innovation and integration in recent years. The HKMA participated in the work of both sub-groups. The work of the Working Group on Liquidity, in particular, has grown in significance in view of the market turmoil triggered by the US sub-prime crisis. The Group will give urgent priority to updating and strengthening the core principles and sound practices guides on liquidity risk management and supervision.

One of the objectives of the EMEAP WGBS is to seek common approaches on the adoption and implementation of good risk management and supervisory practices. Members of the WGBS agreed to adopt a guidance paper on "Recognition of External Credit Assessment Institutions (ECAIs) for Basel II" as a minimum standard for member economies. Adoption of the paper, which was prepared with the assistance of the HKMA, will promote consistency and efficiency in the ECAI recognition process among member economies in their Basel II implementation.

In April, the HKMA co-operated with the Bank for International Settlements and 53 other participating economies in the *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity*. The results of the survey showed that Hong Kong remained the sixth largest foreign exchange centre and seventh largest when over-the-counter derivatives were included.

Accounting and disclosure

Since the adoption of International Financial Reporting Standards (IFRS) in Hong Kong in 2005, Hong Kong-

incorporated AIs have been required by the HKMA to maintain a regulatory reserve to ensure that changes in accounting standards do not lead to a reduction in the overall level of provisions they hold. This requirement is to acknowledge that accounting provisions only deal with losses already incurred, while the Banking Ordinance requires that AIs must maintain adequate provision for losses which will or may occur. In other words, AIs are required to adopt a more forward-looking approach in the provisioning process to maintain an adequate buffer against future deterioration in credit quality.

The HKMA notes that the requirement to maintain a regulatory reserve is in line with the policy of a number of overseas supervisory authorities' post-IFRS implementation, and considers it appropriate to maintain the requirement, particularly for ensuring the adequacy of provisions when the economy turns down. The HKMA will continue to hold discussions with individual AIs on their provisioning practices to ensure they adopt a conservative approach in determining the appropriate level of provisioning, including the regulatory reserve.

Commercial Credit Reference Agency (CCRA)

The CCRA has been operating smoothly since its establishment in November 2004. At the end of December 2007, the CCRA covered more than 57,000 small- and medium-sized enterprises, defined as non-listed limited companies with an annual turnover not exceeding \$50 million. Around 120 AIs were sharing commercial credit data through the CCRA.

The HKMA continues to participate in the Industry Working Group on the CCRA. In 2007, the Group finalised all the implementation details for expanding the coverage of the CCRA, which will be extended to include sole proprietorships and partnerships from 1 March 2008. The continued development of the CCRA will further strengthen the credit risk management of AIs, which in turn will be conducive to improving the safety and soundness of the financial system.

Consumer protection

Code of Banking Practice

The Code of Banking Practice Committee convened by the Hong Kong Association of Banks has been conducting a review of the Code to improve its provisions and keep pace with developments in the banking sector. As a member of the Committee, the HKMA has assisted in the review and contributed to the industry associations. A draft of the revised Code is expected to be ready for consultation with stakeholders in the first half of 2008.

The industry's overall state of compliance with the Code has continued to improve since the introduction of the self-assessment in 2001-2002. The proportion of AIs reporting full or almost full compliance (with five or fewer instances of non-compliance) with the Code increased from 90% to 98.3% in 2005-2006. As a result, the HKMA has reduced the frequency of the self-assessment exercise from every year to every two years.

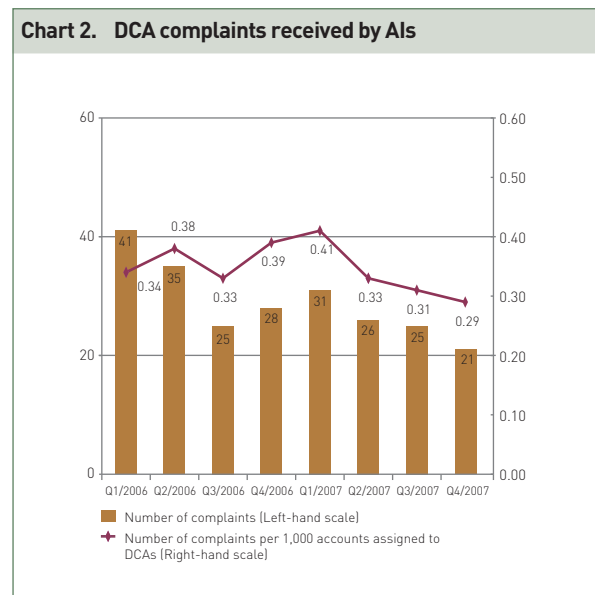
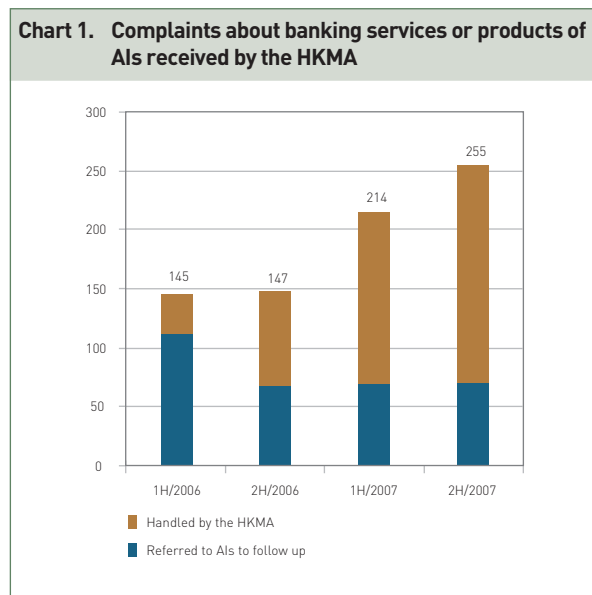
[Consumer Information > Code of Banking Practice](#)

Customer complaints

The HKMA received 469 complaints about banking services or products of AIs in 2007, compared with 292 the previous year (Chart 1). The increase was across all types of banking products, including deposits, loans, credit cards and securities.

There was a continued reduction in the number of complaints received by AIs against their debt collection agents (DCAs). According to the quarterly returns submitted by AIs since March 2002, the number of DCA-related complaints further decreased to 103 in 2007 from 129 in 2006, indicating AIs remained vigilant in monitoring the performance of their DCAs (Chart 2).

[Consumer Information > Complaints about Banks](#)



How the HKMA handles customer complaints

The HKMA has no statutory responsibility for consumer protection. It has a limited role in monitoring AIs' handling of customer complaints, and has issued a guideline to AIs requiring them to handle such complaints thoroughly and promptly.

A revised complaint leaflet has been published by the HKMA to provide the public with more information about its role and procedures in handling customer complaints. As explained in the leaflet, the HKMA reviews all complaints it receives to decide whether and how they can be taken further. Its focus is on whether the AI's complaint handling procedures are working properly and, based on the assessment, it

will decide whether to refer the complaint to the AI for further investigation. Not all complaints will be referred to AIs. If the matter of the complaint is purely commercial, such as relating to cost or quality of banking services, and the AI has handled the complaint in full, the HKMA will not take any further action. However, if there are concerns about the AI's handling of the complaint, the HKMA will refer it to the AI for re-investigation and further reply to the complainant, normally within 30 days. The HKMA will monitor the AI's handling of the complaint and review the reply to the complainant to check that the procedures are appropriate and working properly.

Consolidation of bank branches

Increased competition in the banking sector, together with the introduction of new technology, has led some banks to consolidate their branches. During the year, a special task force set up by the Hong Kong Association of Banks introduced a number of initiatives to minimise the impact of branch closures on the public. These included a simplified version of ATMs for the elderly, the launch of a community-wide ATM education programme, and the extension of EPS cash-back services to convenience stores in addition to the existing supermarket chains.

Securities enforcement

The HKMA has a shared responsibility with the SFC for the enforcement of the rules and regulations on RIs. During the year

- the HKMA conducted preliminary assessments of 40 cases with potential disciplinary concerns and opened investigations into 14 of them (Chart 3), and completed investigations into 13 cases. In six of these cases, recommendations were made by the Monetary Authority to the SFC to exercise disciplinary powers under Section 196 of the Securities and

Futures Ordinance, or warning letters were issued to the RIs and Rels (Chart 4)

- the Monetary Authority took disciplinary action under Section 58A of the Banking Ordinance, the first of its kind, to suspend the particulars of an Rel from the HKMA's register for concealing her securities trading from her employer
- a review of the range of disciplinary sanctions applicable to RIs was conducted. The review, which suggested a more flexible use of fines on RIs, was passed to the SFC
- the frequency of meetings with the SFC on enforcement matters was increased from every six months to every three months, and the side letter to the Memorandum of Understanding was revised in April
- a reciprocal secondment programme with the SFC was established to facilitate mutual understanding of each body's practices to promote consistency in enforcement.

Chart 3. Cases with potential disciplinary concerns reviewed by the HKMA

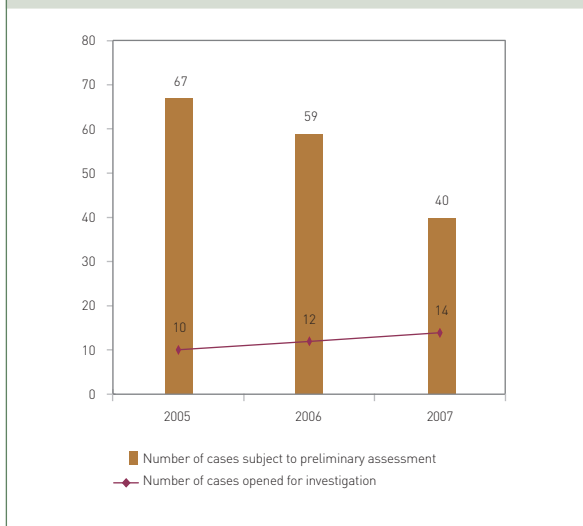
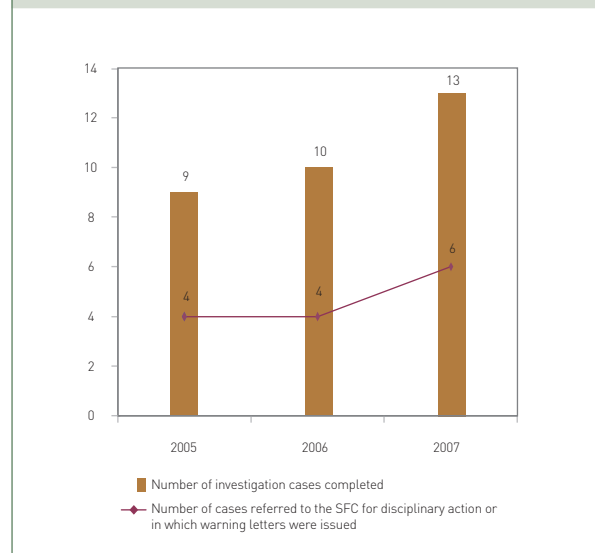
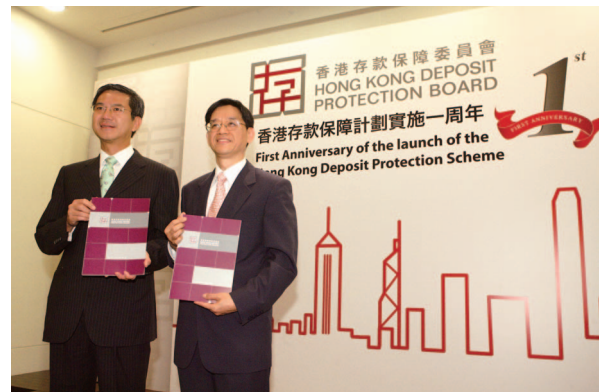


Chart 4. Investigation cases completed



Deposit Protection Scheme

The Hong Kong Deposit Protection Board made good progress in implementing the Deposit Protection Scheme in the first year of its operation. In consultation with industry representatives, the Board devised a number of initiatives to monitor members' compliance with the rules and guidelines governing the operation of the Scheme, which was launched in September 2006. Simulation tests and the payout rehearsal held during the year proved useful in improving the Scheme's readiness for payouts. Opinion surveys conducted in 2007 indicated the Board's publicity activities were effective in fostering and maintaining a high level of public awareness of the Scheme.



Celebrating the first anniversary of the Deposit Protection Scheme are Raymond Li (left), CEO of the Deposit Protection Board who is also Executive Director (Banking Development) of the HKMA, and Professor Andrew Chan, Chairman of the Board.

Licensing

At the end of 2007, Hong Kong had 142 licensed banks, 29 restricted licence banks, 29 deposit-taking companies and 15 approved money brokers. In 2007, the Monetary Authority granted bank licences to seven foreign banks and authorized a transfer of the banking licence of a foreign bank. The Monetary Authority also granted certificates of approval to two money brokers. Three licensed banks, two restricted licence banks and four deposit-taking companies revoked their authorizations.

PLANS FOR 2008 AND BEYOND

Supervisory focus

Credit risk management and asset quality

The local and overseas economic outlook is uncertain given that the full impact of the US sub-prime crisis is still working its way through the global financial system. Tightening credit conditions coupled with the possibility of an economic slowdown in the US and a challenging business environment on the Mainland may have significant implications for the local economy and specific customers of Als. This could develop into a challenge for Hong Kong's Als in managing the associated credit risk amid intense market competition. The HKMA will monitor closely the asset quality of individual Als and assess the adequacy of their systems of internal controls for managing credit risks.

China-related businesses

The HKMA will continue to develop and promote supervisory strategies and policies to help ensure Hong Kong banks develop their China-related businesses in a prudent manner. Contact will be maintained with Mainland authorities to explore new business opportunities and improve cross-border supervisory co-operation. The HKMA will approach the Als regarding the proposed pilot scheme for Mainland residents to invest directly in listed securities in Hong Kong once details are available to ensure that they have adequate internal controls and operational capacity to cater for the new business.

Supervision of technology and operational risks

Internet banking, technology risk and business continuity management

With the anticipated growth in on-line securities trading and Als' increasing dependence on technology, the HKMA will step up its supervision of Als' Internet banking and technology risk management. In particular, two rounds of thematic examinations are planned in 2008 to cover the system-capacity planning and contingency arrangements for on-line securities trading services, and the migration of the Real Time Gross Settlement and Central Moneymarkets Unit systems to the SWIFTNet infrastructure. In addition, detailed on-site examinations will be conducted for the development and support of systems related to Basel II. The HKMA will invite Als to perform supervisory control self-assessment on Internet banking, technology risk management and business continuity management. It also plans to work with the Hong Kong Association of Banks and the Hong Kong Police Force to develop an effective customer education programme in 2008 to promote sound control practices and awareness of emerging fraudulent techniques.

Operational risk management

Emerging operational risks of Als will be identified and addressed through specialist on-site examinations or off-site reviews, and an effective supervisory framework will be developed on high-risk areas, such as outsourcing arrangements.

Supervision of securities and insurance businesses

The HKMA will work with the SFC and the Insurance Authority on the supervision of Als' securities and insurance businesses, including the review of regulatory standards for the selling of investment-linked insurance products.

With the riskier nature of credit-linked investment products and the recent volatile market conditions, the HKMA will conduct thematic examinations of RIs' selling retail credit-linked investment products in 2008. Thematic examinations on the compliance monitoring of securities activities will be performed to ascertain whether RIs have sufficient controls to ensure their securities activities are conducted in compliance with legal and regulatory requirements.

Supervision of treasury activities

The HKMA will undertake a series of examinations in 2008 on the risk management practices and capabilities of selected AIs' treasury operations with regard to their investments in complex structured products. This is designed to identify and recommend sound industry practices for the AIs. The HKMA will also continue its specialised on-site examinations of AIs' treasury operations.

Further specialisation of supervisory work

Following a review of its supervisory process, the HKMA considers further specialisation in the supervision of selected risks and business areas of the banking sector will help improve supervisory efficiency in view of the growing complexity in banking operations. As a result, further specialisation in the supervision of commercial banking, consumer finance, wealth management and private banking will be implemented.

Basel II Implementation

Monitoring and assessment of impact

The HKMA will monitor AIs' compliance with the revised capital adequacy framework and the impact of Basel II on AIs. For banks that have received approval to use the IRB approach, the HKMA will analyse their IRB data to assist the supervisory monitoring of their credit risk profile. To firm up the implementation strategy for other advanced approaches, such as those for the calculation of counterparty credit risk or operational risk, the HKMA will assess AIs' readiness for adopting

these approaches. It will also monitor the development of international standards by the Basel Committee, particularly in relation to the definition of capital base, securitisation framework and Pillar 2, and will consider incorporating appropriate changes to the capital adequacy framework, where necessary.

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

In the light of implementation experience and market events which occurred during 2007 (for example, the sub-prime crisis), the HKMA will review the need for amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules. However, it is expected that amendments, if needed, will be mainly for refinement and clarification.

Supervisory recognition for use of IRB approach

In 2008, the recognition process will focus on AIs applying to adopt the IRB approach from 2009 to 2011. On-site examinations of AIs intending to adopt the IRB approach in 2009 have been scheduled and the HKMA will maintain regular dialogue with AIs planning to adopt the IRB approach in 2010 or 2011.

The HKMA will also conduct follow-up reviews of the approved IRB AIs to ensure that issues identified in the previous on-site examinations are fully addressed and appropriate refinements made to their internal rating systems.

Supervisory review process

Implementation of the SRP assessment framework in 2007 has provided valuable experience. The HKMA will identify areas where the framework can be further enhanced. AIs' compliance with the capital adequacy and risk management standards will be monitored and the need for more guidance to help them upgrade their existing systems will be considered.

Capital adequacy assessment process

An important focus of the HKMA in 2008 will be to monitor Als' progress in developing their CAAPs and evaluate their effectiveness. More guidance will be provided, if necessary, to assist the Als in developing or improving their CAAPs to meet supervisory standards.

Review of the HKMA's work on banking stability

The HKMA has commissioned a review on how best it can discharge its responsibilities in promoting banking stability. The review takes into account recent and likely future developments in Hong Kong's banking system and the changing nature of the risks, such as the globalisation of finance and banking business and the increasing integration of the financial systems of Hong Kong and Mainland China.

The review, being conducted by a consultant who is an expert on banking supervision both in Hong Kong and around the world, coincides with the end of the programme of banking sector reforms initiated in 1999.

The current review aims to make recommendations on the focus and priorities of the HKMA's banking supervisory functions in the next five years or so. Based on a combination of paper and statistical research and interviews with key stakeholders in Hong Kong's banking system, the review is expected to be completed in the second quarter of 2008. The HKMA will study the consultant's recommendations before deciding on a policy response.

Review of liquidity regime

Market turmoil which emerged from the US sub-prime crisis in 2007 has clearly demonstrated the importance of liquidity risk management and supervision. The HKMA's supervisory framework on liquidity risk was last revised some years ago, which led to the issue of the SPM on "Liquidity Risk Management" in 2004. To ensure the supervisory framework remains appropriate to address recent market issues, the HKMA will review

its current liquidity regime in 2008, focusing on the following aspects:

- use of stress-testing and scenario analysis (with emphasis on market-wide stress scenarios) for liquidity risk management
- complex financial instruments and their implications for liquidity risk management
- management of contingent liquidity risk (including risks from off-balance sheet vehicles)
- effectiveness of banks' contingency funding plans
- adequacy of liquidity reporting requirements.

Development of supervisory policies

Key policies and guidelines to be developed in 2008 include:

Counterparty credit risk management

This supervisory guideline will describe the approach to be adopted by the HKMA in supervising Als' CCR and set out the main elements of an effective management system, having regard to applicable requirements under the Basel II framework, recommendations of the Counterparty Risk Management Policy Group, relevant supervisory requirements of other leading supervisors, and industry practices on CCR management.

Internal audit and compliance functions

The HKMA will provide guidance on its expectations for Als' internal audit and compliance functions. Strong internal audit functions improve the effectiveness of risk management, control and governance. Adequate compliance acts as a "gatekeeper" to ensure Als' conformity with rules, standards and procedures.

Consolidated supervision

The HKMA practises a group-wide approach to supervision of Hong Kong-incorporated AIs, where they form part of a financial group of companies, in line with the relevant standards contained in the *Basel Core Principles for Effective Banking Supervision*. The HKMA intends to prepare a supervisory guideline to outline its approach, requirements and practices to effect consolidated supervision of AIs.

Prevention of money laundering and terrorist financing

Hong Kong's AML and CFT supervisory framework will continue to be reviewed and updated in the light of developments, including the recommendations arising from the joint mutual evaluation by the FATF and the APG. The HKMA will undertake institution-specific and thematic examinations to ensure that AIs remain vigilant in combating the problem, and will continue to develop the Industry Working Group to engage AIs on relevant issues and proposals for practical guidelines for the industry.

Revised Basel Core Principles

The HKMA is in the process of conducting a self-assessment of its compliance with the revised *Basel Core Principles* released by the Basel Committee in October 2006, focusing on the new key updates such as those on risk management and consolidated supervision, with a view to identifying areas for further improvement.

Consumer protection

The HKMA will continue to promote industry self-regulation and improvement in the standards of banking practices through participation in the Code of Banking Practice Committee. It will assist the industry associations in completing the review of the *Code of Banking Practice* and monitor AIs' compliance with the Code through regular self-assessments and the handling of complaints about banking services.

Deposit Protection Scheme

The HKMA will continue to assist the Hong Kong Deposit Protection Board in operating the Deposit Protection Scheme. The Board will start implementing the various mechanisms developed in 2007 for monitoring Scheme members' compliance with the rules and guidelines of the Scheme. Enhancements will be made to the payout systems and processes in the light of the experience gained from the simulation tests and payout rehearsal. Further simulation tests and a payout rehearsal will be conducted to maintain and improve the Scheme's readiness. The Board will continue to promote the key features of the Scheme to the public through various promotional and educational channels.



Market Infrastructure

A fully fledged Renminbi RTGS system was launched in 2007. System improvements helped increase RTGS efficiency to meet higher turnover. An electronic bond trading platform and the link between Malaysia's debt securities settlement system and Hong Kong's US dollar RTGS system were launched. The Exchange Fund Bills and Notes programme was further improved. A study was also completed on developing an Islamic bond market in Hong Kong.

OBJECTIVES

One of the HKMA's key policy objectives is to promote the development of a safe and efficient financial market infrastructure to help maintain financial and monetary stability and Hong Kong's status as an international financial centre. Particular attention is paid to the clearing and settlement systems for the safe and efficient transfer of funds and securities within Hong Kong and between Hong Kong and other financial centres, especially the Mainland.

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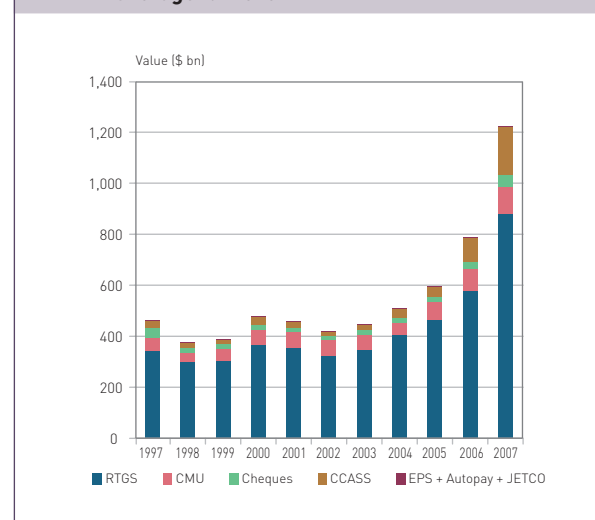
Hong Kong dollar interbank payment system

The Hong Kong dollar Clearing House Automated Transfer System (CHATS), which operates on a Real Time Gross Settlement (RTGS) basis, is responsible for clearing all Hong Kong dollar interbank payments. It has a direct link with the Central Moneymarkets Unit (CMU), which is the debt securities clearing and settlement system operated by the HKMA, to provide both real-time and end-of-day delivery-versus-payment (DvP) settlement services. Hong Kong Interbank Clearing Limited (HKICL), the system operator of CHATS, was established in 1995 and is owned equally by the HKMA and the Hong Kong Association of Banks. In 2007, HKICL processed a daily average of \$879 billion in CHATS transactions (22,367 items). On 5 November the system registered a record turnover of \$1.67 trillion because of a large initial public offering (IPO).

In addition to settling large-value payments, CHATS also handles daily bulk clearings of stock market transactions, credit card transactions, cheques and auto-debit transactions, low-value bulk electronic payment items (EPS and auto-credit), and low-value ATM transfers (Chart 1).

During the year, banks made good use of their Exchange Fund Bills and Notes (EFBN) to obtain interest-free intraday liquidity through intraday repurchase agreements with the HKMA to settle their interbank payments. On average, intraday repurchase transactions amounting to \$59.8 billion were carried out each day, representing 62% of the \$96 billion in Exchange Fund paper held by banks in December 2007.

Chart 1. Hong Kong dollar payment system daily average turnover



The CCASS Optimiser and other new measures

A number of new measures have been introduced to the RTGS and CMU systems to improve system efficiency and to support increased turnover arising from stock market activities.

The CCASS Optimiser is a mechanism that settles money items for stock market transactions and large-value CHATS payments simultaneously and on a net basis. As money items for stock market transactions are settled daily in a bulk run at a specific time by multilateral netting, banks can use the CCASS Optimiser to offset CHATS payments during the bulk settlement run. This makes it easier for banks to manage their funding more efficiently and promotes the smooth and effective functioning of the system.

The opening time of the Hong Kong dollar RTGS and CMU systems was advanced by half an hour to 8:30 a.m. to provide more time for banks to arrange funding for payments.

An improved eIPO service that supports multiple receiving banks was introduced jointly with the Hong Kong Association of Banks and Hong Kong Exchanges and Clearing Limited. With the upgraded service, the proportion of IPO application monies submitted through electronic channels has increased and, more importantly, IPO statistics are made available earlier to facilitate better liquidity management and recycling of funds.

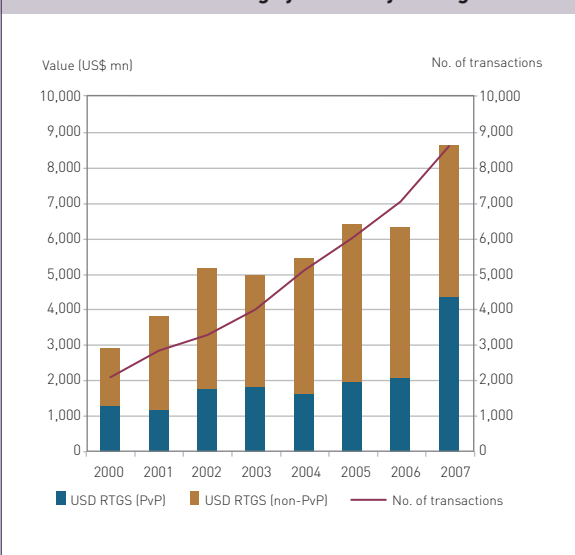
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US dollar RTGS system

The US dollar RTGS system has been operating efficiently since its launch in 2000. The Hongkong and Shanghai Banking Corporation is the settlement institution with HKICL as system operator. At the end of 2007, the system had 74 direct and 157 indirect participants, including 129 indirect participants from outside Hong Kong. On average,

it handled more than 8,600 transactions, with a total value of US\$8.6 billion, a day in 2007 (Chart 2). Buoyed by large IPO-related payments, the turnover of the US dollar RTGS system set a record of US\$22.42 billion on 23 November. The system processed an average of 7,457 US dollar cheques, with a value of US\$216 million, a day in 2007.

Chart 2. US dollar clearing system daily average turnover



Euro RTGS system

The euro RTGS system was launched in 2003. The settlement institution is Standard Chartered Bank (Hong Kong) Limited, with HKICL as system operator. At the end of 2007, there were 28 direct and 20 indirect participants, including 11 indirect participants from outside Hong Kong. In 2007, the system handled on average 163 transactions, with a total value of over €1.1 billion, a day (Chart 3).

The RTGS system links with Shenzhen and Guangdong handled more than 26,700 transactions during the year, with a total value equivalent to over \$319.3 billion. The system enables cross-border payments in Hong Kong dollars and US dollars between banks in Hong Kong and their counterparts in Shenzhen and Guangdong to be settled efficiently and safely.

Payment links with the Mainland

In response to the increasing demand for cross-border payment services, the HKMA has been working closely with Mainland authorities to establish cross-border payment links. The use of these links has risen gradually over the years. In 2007, the average daily turnover of cross-border payments handled by the various system links was over \$1.5 billion (Chart 4).

Chart 3. Euro clearing system daily average turnover

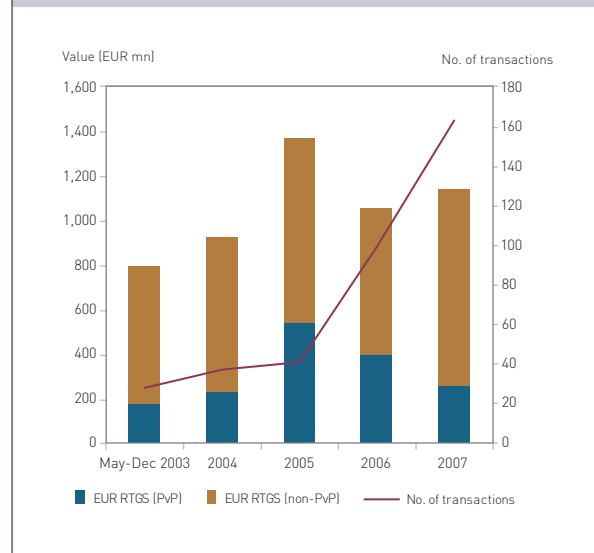
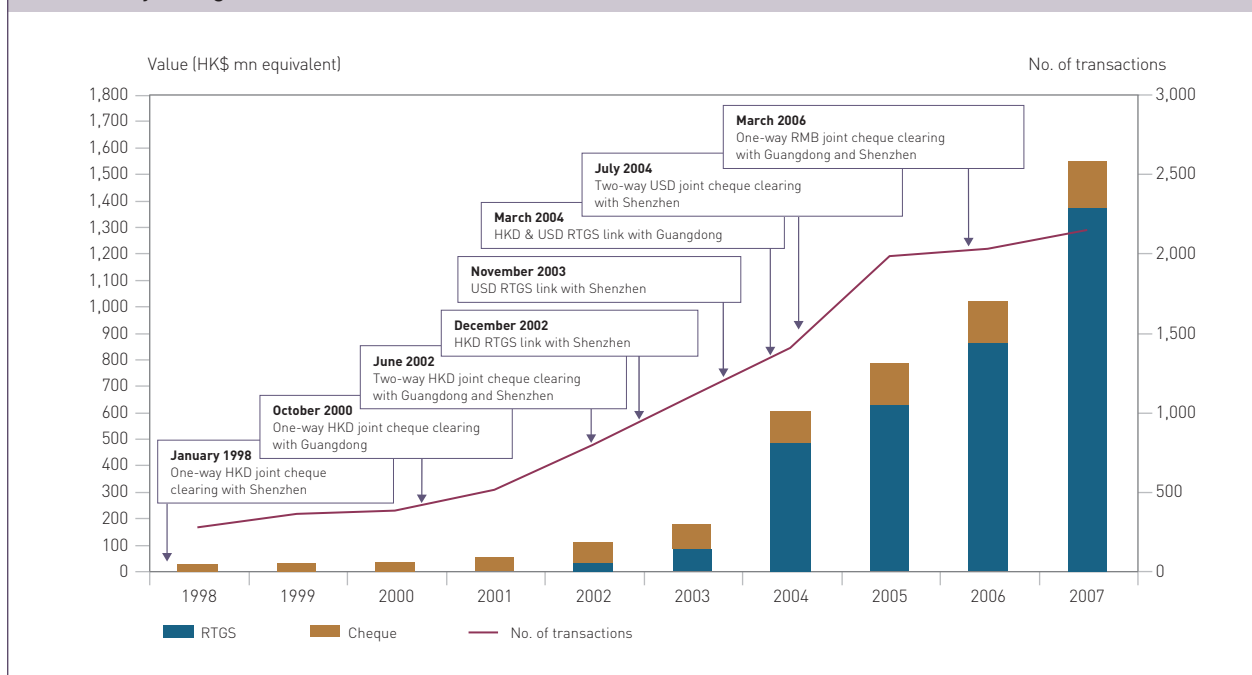


Chart 4. Daily average turnover in cross-border links



The two-way joint cheque clearing facilities cleared 472,997 Hong Kong dollar and US dollar cheques, with a value equivalent to \$41 billion in 2007. The facilities shortened the clearing time for cheques drawn on banks in Hong Kong that were presented in Shenzhen and Guangdong, and vice versa. Since March 2006, the joint cheque-clearing facilities have been expanded to cover renminbi cheques drawn on banks in Hong Kong, and presented in Shenzhen and Guangdong for consumer spending. In 2007, renminbi cheques with a total value equivalent to \$25 million were cleared.

Debt settlement systems

The CMU provides an efficient, one-stop clearing, settlement and depository service for Hong Kong

dollar and other international debt securities. Since its establishment in 1990, the CMU has developed links with many regional and international central securities depositories. Overseas investors can now hold and settle securities lodged with the CMU. It also helps Hong Kong investors to hold and settle foreign securities held with regional and international central securities depositories.

In 2007, the CMU processed a daily average value of \$48.6 billion (159 transactions) in secondary market transactions. Among the debt securities lodged with the CMU at the end of the year, the outstanding amount of EFBN was \$136.6 billion and the total amount of other securities was equivalent to \$263.1 billion.

Financial infrastructure review

The HKMA completed a comprehensive review of Hong Kong's financial infrastructure in 2005 with the aim of developing a safe and efficient multi-currency, multi-dimensional clearing and settlement platform and helping turn Hong Kong into a regional payment and settlement hub. After implementing a number of projects in 2006, the HKMA continued to make progress in 2007, completing most of the review's recommendations. New project development and business promotion opportunities were also identified during the year.

Project development

The **Renminbi Settlement System** launched in March 2006 was upgraded to a fully fledged RTGS system in June 2007 to cater for the issuance of renminbi bonds and future expansion of renminbi business. The Renminbi RTGS system has developed an automated link with the CMU to provide DvP settlement for renminbi bonds in Hong Kong. This new infrastructure handles the clearing, settlement, custody and payments associated with renminbi bonds issued in Hong Kong. In 2007, total issuance of renminbi bonds amounted

to RMB10 billion and the RTGS system handled 356 transactions with a total value of RMB211 million a day on average.

The **DvP link between Malaysia's debt securities settlement system and Hong Kong's US dollar RTGS system** was launched in October 2007, one year after the successful implementation of the link between Malaysia's ringgit RTGS system and Hong Kong's US dollar RTGS system. The DvP link helps eliminate settlement risk by ensuring the simultaneous settlement of securities in Malaysia and US dollars in Hong Kong.

The **one-way joint clearing facility for Hong Kong dollar cheques between Hong Kong and Macau** developed jointly with the Monetary Authority of Macao was launched in August 2007. The facility, which aims to fulfil the growing need for efficient payment services between Hong Kong and Macau, has more than halved the time required for clearing Hong Kong dollar cheques issued by banks in Hong Kong and presented in Macau, from four or five working days to two. In 2007, over 21,400 Hong Kong dollar cheques with a total value of \$2,869 million were cleared.

Financial infrastructure review (cont'd)

An **electronic bond trading platform** was launched in December 2007 for the trading of bonds in Hong Kong, primarily for EFBN. It has helped improve the price transparency among market players and streamline the trading process. The platform will be linked to the CMU to facilitate straight-through processing.

The **Regional CHATS service** was launched in July 2007 to process cross-border commercial payments through Hong Kong using its RTGS systems during Asian business hours. By the end of December, 34 banks in Hong Kong had registered as service providers for cross-border payment services, covering over 1,860 payment beneficiary points in 42 economies.

The **migration to SWIFTNet** aims to replace the existing proprietary platform of the various RTGS systems and the CMU with an open platform to improve compatibility with other clearing and settlement systems and make it easier for overseas banks to use Hong Kong's RTGS systems.

Business development

To further expand the Hong Kong's multi-currency and multi-dimensional infrastructure network, the HKMA will continue to explore opportunities to link the RTGS systems and the CMU with other clearing and settlement systems in the region, and to promote

greater use of Hong Kong's services. A comprehensive marketing programme has been implemented to pursue these objectives through seminars and visits to potential users in the Asia Pacific region, with over 220 marketing calls being made in 2007.

Promoting links with other Asian economies – building on the success of the payment-versus-payment (PvP) and DvP links with Malaysia, discussions with central bank authorities and system operators, including those in Mainland China, Thailand, Indonesia and Dubai, were held during the year.

Promoting the use of Hong Kong's clearing and settlement platform – marketing calls and seminars were arranged in a number of Asian economies, including those in the Indian Subcontinent and the Middle East. As a result, a number of banks in the region and some international financial institutions have started to settle the US dollar legs of their foreign exchange transactions in Hong Kong. Leveraging on Hong Kong's US dollar CHATS, Euroclear Bank, an international central securities depository, offered Asian-time-zone US dollar payment facilities to its members in the region.

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Oversight of clearing and settlement systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO) empowers the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre. The CSSO is designed to promote the general safety and efficiency of designated systems including the CMU, Hong Kong dollar CHATS, US dollar CHATS, Euro CHATS and the Continuous Linked Settlement (CLS) System. Except for the CLS System, the HKMA oversees the designated systems through off-site reviews and continuous monitoring, on-site examinations and meetings with management.

In 2007, all designated systems were found to be in compliance with the safety and efficiency requirements under the CSSO.

Co-operative oversight arrangements

Clearing and settlement systems have become increasingly inter-dependent, leading to the establishment of international co-operative oversight arrangements.

The CLS System, a designated system in Hong Kong, is operated by CLS Bank, which is primarily regulated by its home supervisor, the US Federal Reserve. The HKMA and other central banks (including the US Fed) participate in the international co-operative oversight of the CLS System. Since the CLS system has expanded its settlement services to non-PvP transactions, the HKMA has been working closely with other central banks to

discuss and identify issues that may arise because of this expansion.

Following the establishment in November 2006 of the US dollar/ringgit PvP link between the US dollar CHATS in Hong Kong and RENTAS in Malaysia, the HKMA and Bank Negara Malaysia established a co-operative oversight arrangement for the PvP link in December 2006. This arrangement also covered the US dollar CHATS-RENTAS DvP link established in October 2007. Under the arrangement, an information sharing mechanism was set up through which the two parties agree to alert each other about issues that may affect the operations of the link. The arrangement has proved effective.

The central banks of the G10 countries agreed that SWIFT, a major global message carrier for payment systems, should be subject to co-operative oversight by central banks, with the National Bank of Belgium as the lead overseer since the carrier is incorporated in Belgium. As the CMU accepts SWIFT messages and all the local designated systems will migrate to the SWIFTNet platform, the HKMA has an interest in the oversight of the system. In 2007, the HKMA monitored the development of SWIFT's oversight framework and was involved in discussions with other central banks and with the National Bank of Belgium.

Independent tribunal and committee

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

An independent Process Review Committee reviews processes and procedures adopted by the HKMA in applying standards set under the CSSO to systems in which the HKMA has a legal or beneficial interest. The Committee uses the procedures in the Internal Operating Manual, which sets out the procedures for evaluating the designated systems' compliance with the oversight standards, as the benchmark to assess whether the HKMA has applied the same set of procedures to all designated systems. Quarterly reports and management reports summarising the HKMA's oversight activities were submitted to the Committee.

The Committee held two meetings in 2007, reviewing four quarterly reports and 25 accompanying oversight activities management reports of the designated systems. The Committee concluded that it was not aware of any cases where the HKMA had not duly followed the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities. The Committee submitted its annual reports, which are available on the HKMA's website, to the Financial Secretary.

Informal oversight of retail payment systems

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

In August 2005, the HKMA endorsed the *Code of Practice for Multi-purpose Stored Value Card Operation* issued by Octopus Cards Limited (OCL) and is responsible for monitoring OCL's compliance with the Code. In 2007 OCL completed its second annual self assessment. During the year the HKMA helped to facilitate discussions with the industry to explore possible ways of introducing competition to the market.

In December 2006, a *Code of Practice for Payment Card Scheme Operators* was drawn up and issued by eight credit and debit card scheme operators with the support of the HKMA. The Code sets out the principles covering operational reliability, data and network security, and the efficiency and transparency of payment card operations in Hong Kong. The HKMA monitors the payment card scheme operators' compliance with the Code, and all operators are required to perform an annual self-assessment of their compliance and to report to the HKMA any incident which may have material and adverse impact on cardholders.

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International participation

In addition to the international co-operative oversight arrangements, the HKMA participated in other regional and international forums for payment system overseers to discuss issues of mutual interest, including interdependencies between payment and settlement systems, and international principles and standards on payment and settlement systems. The HKMA also took part in an international foreign exchange survey conducted by the Bank for International Settlements to assess the progress being made in reducing foreign exchange settlement risk.

Market Infrastructure

Debt market development

Gross issuance of Hong Kong dollar debt amounted to \$445 billion in 2007, declining by 2% from \$454 billion in 2006 (Chart 5). Overseas borrowers became generally less active in the local primary market compared with the previous year. Multilateral development banks (MDBs) and other overseas borrowers reduced their issuance from \$3 billion and \$147 billion to \$1.7 billion and \$131 billion respectively, although the latter remained the most active issuers tapping the local market after the Exchange Fund. Issuance by statutory bodies and government-owned corporations and authorized institutions grew by 11% and 13% respectively, while that by local corporations declined by 13%.

The value of outstanding Hong Kong dollar debt rose slightly by 2% to \$764 billion at the end of 2007, compared with \$748 billion a year earlier (Chart 6). Overseas borrowers excluding the MDBs were the largest group of borrowers in the local debt market with outstanding debt amounting to \$350 billion. With more debt maturing than was issued during the year, the outstanding debt issued by authorized institutions declined by 7% to \$137 billion at the end of 2007.

During 2007 the HKMA completed the second phase of the review on debt market development, which examined issues related to the investor base, issuer base, regulation, taxation, and market infrastructure. The study made a number of recommendations associated with the regulatory process, investment benchmarks and guidelines, and tax treatments with the aim of attracting issuers and broadening the investor base. The findings and recommendations have been submitted to the Government.

The HKMA also initiated a study on developing an Islamic finance platform in Hong Kong drawing on the expertise of the Treasury Markets Association (TMA). The study was designed to assess the market potential and identify existing hurdles to the development of an Islamic bond market in Hong Kong, and to make recommendations on any changes that might be needed in the taxation, legal and regulatory framework. The findings suggest that Hong Kong's existing legal and regulatory infrastructure can readily support the development of an Islamic bond market. However, Hong Kong's tax laws need to be changed or clarified to provide a level playing field for the issuance of Islamic bonds in Hong Kong. A report containing policy recommendations was submitted to the Government in late 2007.

Chart 5. New issues of Hong Kong dollar debt instruments

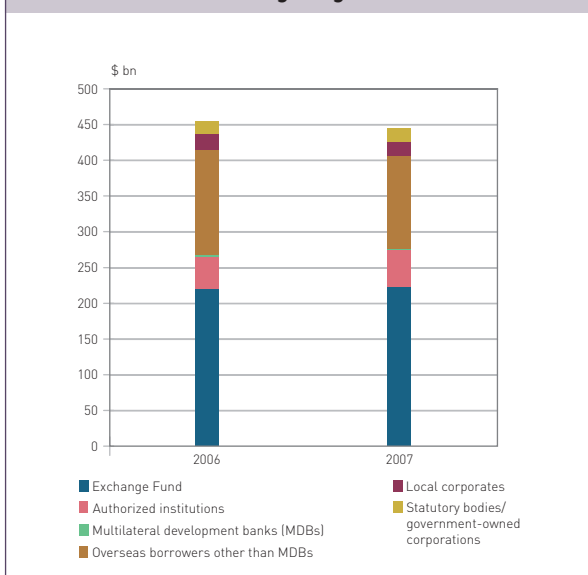
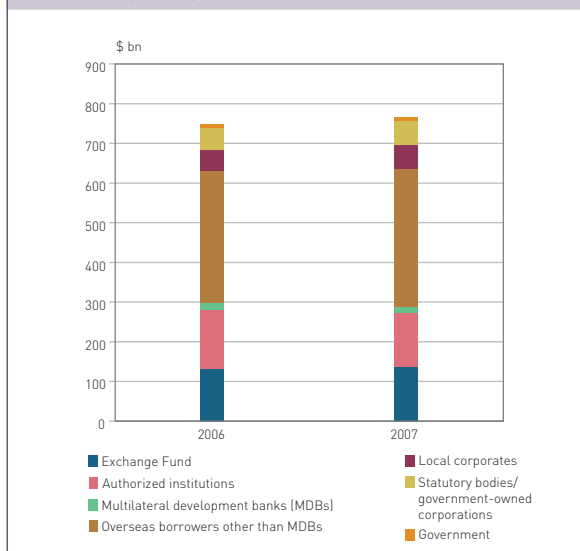


Chart 6. Outstanding amount of Hong Kong dollar debt instruments



Exchange Fund Bills and Notes programme

During 2007, the HKMA implemented the recommendations from the review of the EFBN programme completed in late 2006. These included:

- refining the market-making system for EFBN by publishing, starting from December 2006, half-yearly league tables of top-performing market makers for Exchange Fund Bills (EFB) and Exchange Fund Notes (EFN) to encourage them to trade the EFBN. From July 2007, exclusive tender rights for EFB and EFN were granted to market makers in the league tables
- extending the benchmark yield curve with the inaugural issue of the 15-year EFN (expected to be issued every six months) in August 2007
- streamlining the issuance programme by removing the seven-year EFN following the launch of the 15-year EFN

- introducing an electronic trading platform for EFBN in December 2007 to improve the price transparency and streamline the trading process of EFBN.

In addition to implementing the review's recommendations, the HKMA continued to fine-tune the maturity mix of the EFBN portfolio to increase liquidity at the longer end. The EFBN maturity profile was adjusted by increasing the issuance of five- and 10-year EFN, and the launch of 15-year EFN. The share of EFN with remaining maturity of more than one year and up to five years increased to 62% in 2007 from 59% in 2006 (Table 1). A progressively more balanced distribution along the EFBN yield curve can facilitate the pricing of private and public sector debt products. During the year, three retail issues of the two-year EFN, totalling \$587 million, were launched and were well received by the market.

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Table 1. Outstanding issues of Exchange Fund Bills and Notes

	2007	2006
	(in millions of Hong Kong dollars)	
Exchange Fund Bills (by original maturity)		
91 days	38,546	36,288
182 days	16,900	16,900
364 days	16,900	16,900
Sub-total	72,346	70,088
Exchange Fund Notes (by remaining tenor)		
1 year or below	13,800	14,400
Over 1 year and up to 3 years	25,000	22,600
Over 3 years and up to 5 years	14,800	14,000
Over 5 years and up to 10 years	10,100	10,700
Over 10 years	600	0
Sub-total	64,300	61,700
Total	136,646	131,788

Treasury Markets Association

Building on the public sector-private sector partnership, the HKMA is working closely with the market and providing strategic support to the TMA, whose mission is to further promote the professionalism and competitiveness of Hong Kong's treasury markets. The Association, currently chaired by the HKMA's Deputy Chief Executive, Mr Eddie Yue, completed another successful year in 2007:

- Membership: nearly 2,000 individual and 86 institutional members from banks, investment houses, insurance companies, money brokers and large corporations had joined the TMA by the end of the year.
- Qualifications: the TMA developed the Treasury Markets Certificate and the Treasury Markets (Debt Securities) Certificate in collaboration with the Hong Kong Institute of Bankers and the Hong Kong University of Science and Technology as part of the professional qualifications for its members. At the end of 2007, more than 200 individuals had completed the courses.
- More than 50 seminars, workshops and talks were organised during the year for both individual members and staff of institutional members to keep them abreast of market trends and development.
- Market development: to tie in with the debut issuance of renminbi bonds in Hong Kong and to facilitate their trading, the TMA introduced a daily renminbi bond price fixing in July, developed an information sheet on renminbi bond documentation, and developed an annex to the Global Master Repurchase Agreement for renminbi bonds.
- The TMA formed a working group in August 2007 to examine the prospects of developing an Islamic

bond market in Hong Kong and submitted its recommendations to the Government. Another working group was formed to examine the status of the foreign exchange market in Hong Kong and make recommendations at both policy and market levels to further improve market development.

- Treasury market promotion: to promote Hong Kong's financial infrastructure and treasury markets to the Mainland, the HKMA and the TMA jointly organised the Treasury Markets Summit in Beijing in December. The summit was attended by over 400 participants from Mainland financial institutions and corporations, and sponsored by 13 financial institutions in Hong Kong. In October 2007, the TMA hosted the Executive Committee and Council meetings of the ACI-Financial Markets Association in Hong Kong. Throughout the year, representatives of the Association also took part in major international forums to maintain close contact with overseas counterparts.

PLANS FOR 2008 AND BEYOND

The priority in 2008 is to continue with the review of the retail payment system and the role of the CMU, both started in 2007, and to plan for the implementation of the recommendations arising from these studies. As a sponsor, the HKMA is heavily involved in the progress of the SWIFTNet migration, which will help provide a safe and efficient multi-dimensional clearing and settlement platform in Hong Kong for regional use. Ensuring the safe and efficient operation of the RTGS systems and the CMU continues to be a key role for the HKMA as they are instrumental in maintaining the stability and integrity of Hong Kong's monetary and financial systems.

Further steps will be taken to develop Hong Kong into a regional payment and settlement hub, and the HKMA will continue to develop the EFBN programme as part of its plan to develop the local debt market. Follow-up actions will be taken together with the Government and

other authorities to implement recommendations from the Phase Two review of the debt market. Initiatives to establish an Islamic finance platform in Hong Kong will be pursued in conjunction with the TMA and the Government.

As the overseer of designated systems under the CSSO, the HKMA will continue to be involved in promoting their safety and efficiency.

A self-regulatory approach for retail payment systems has been implemented through the two Codes of Practice covering multi-purpose stored value cards, and credit and debit cards. The HKMA will continue to monitor the operators' self-compliance with the Codes. And the HKMA will discuss with the industry possible ways to promote competition in the small-value retail payment markets.

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



International Financial Centre

The HKMA stepped up its efforts in regional surveillance and monitoring of risks to financial stability in the region and in Hong Kong. Research into and monitoring of developments in Mainland China were also strengthened. Significant progress was achieved in the implementation of the Action Agenda on “China’s 11th Five-Year Plan and the Development of Hong Kong”. Following a number of upgrades during the year, the credit ratings given to Hong Kong by all major international credit rating agencies were at an all-time high of “AA”.

OVERVIEW

Global financial markets experienced a challenging year in the face of the sub-prime crisis. While there was no sign of a direct impact on Asian economies, tensions in the US and European markets caused increased volatility and heightened risks in markets in the region. Economic and financial developments in Mainland China continued to be favourable, but inflation reached new highs as a result of rising energy and food prices.

These developments highlighted the importance of promoting financial stability in the region and in Hong Kong. The HKMA stepped up its efforts in regional surveillance with the co-ordination of a macro-monitoring framework for the Monetary and Financial Stability Committee (MFSC) established under the Executives’ Meeting of East Asia-Pacific Central Banks (EMEAP)¹. Research into and monitoring of developments in Mainland China were also strengthened. In financial co-operation initiatives with the Mainland, the HKMA played a key role in the implementation of the Action Agenda on “China’s 11th Five-Year Plan and the Development of Hong Kong”. This collaborative work with Mainland authorities resulted in significant achievements, including the issuance of renminbi bonds in Hong Kong, the first outside the Mainland; the addition of five new measures for the banking sector under the Closer Economic Partnership Arrangement (CEPA); and the expansion of

the investment scope of offshore wealth management services offered by banks on the Mainland.

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Regional co-operation and participation in multilateral institutions

With closer economic and financial integration in Asia, the HKMA continued to organise and participate in regional initiatives and discussions on a wide range of issues. During the year, the HKMA organised a number of international and regional meetings and seminars to bring together monetary and financial experts to discuss issues of significance and interest. This included a high-level seminar, co-organised with the International Monetary Fund, on the role of hedge funds in Asian financial markets. It was attended by more than 40 senior representatives from central banks in the region and the world’s major financial markets, regulatory bodies, international financial institutions and the private sector.

The HKMA attended meetings of the Asia-Pacific Economic Co-operation (APEC) forum, the Financial Stability Forum and the Bank for International Settlements. These forums provide useful channels for the HKMA to exchange views with the international community and promote understanding of monetary and financial issues in Asia and Hong Kong.

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

The International Finance Corporation, a member of the World Bank Group, expanded its Hong Kong-based Regional Office for East Asia and the Pacific to better serve its increasing operations in the region. This further underscored the role of Hong Kong as an international financial centre in hosting the regional and local offices of international financial institutions.

Promoting monetary and financial stability in Asia

The MFSC was established under EMEAP during the year to strengthen macro-monitoring in the region. Under the auspices of the MFSC, the HKMA developed an integrated monitoring framework, drawing together the macroeconomic developments and financial conditions in each EMEAP economy, and the interrelationship of such factors, with focused analysis of potential contagion risks and implications for regional financial stability. The monitoring framework was endorsed by the MFSC and EMEAP Governors and was launched in November with the HKMA acting as the co-ordinator for inputs from EMEAP members. In support of the MFSC's continuing work on regional surveillance, the monitoring framework will be used regularly at EMEAP meetings.

Upgrading Hong Kong's sovereign credit ratings

The HKMA continued to work closely with the Government to present a balanced assessment of Hong Kong's economic and financial strengths to international credit rating agencies (CRAs). A better sovereign credit rating helps lower the funding costs of Hong Kong debt issuers and increase market confidence in the Linked Exchange Rate system and monetary stability.

Building on previous discussions with CRAs, a more targeted approach was adopted to improve their understanding of Hong Kong's fiscal sustainability and the potential benefits and risks of increasing links with the Mainland. Quantitative analyses established a strong case for an AAA rating for Hong Kong on a stand-alone basis, while stress tests demonstrated that the resilience of Hong Kong's economy and financial systems helps limit the potential impact on Hong Kong of risks originating from the Mainland. Hong Kong was shown to be well positioned to benefit from Mainland China's capital account liberalisation and economic expansion through the financial and real-sector channels.

These efforts contributed to a number of upgrades in 2007 reflecting international recognition of Hong Kong's strong economic fundamentals, improved public finances and growth prospects. Hong Kong's ratings were upgraded by two international CRAs, both by one notch, and the outlook was upgraded to "positive" by another CRA. The credit ratings given by all major international CRAs were AA, the highest ever assigned to Hong Kong.

Advancing financial co-operation with the Mainland

The HKMA assisted in the implementation of the Action Agenda on “China’s 11th Five-Year Plan and the Development of Hong Kong” released in January 2007. The overall aim of the Action Agenda is to develop Hong Kong’s status as China’s international financial centre by establishing a mutually assisting, complementary and interactive relationship between the financial systems of Hong Kong and the Mainland in five areas:

- (i) expanding the presence of Hong Kong financial institutions on the Mainland;
- (ii) increasing the outward mobility of the Mainland’s investors, fund-raisers and financial institutions through Hong Kong;
- (iii) allowing Hong Kong financial instruments to be traded on the Mainland;
- (iv) enhancing Hong Kong’s capability in handling financial transactions denominated in renminbi; and
- (v) strengthening the financial infrastructure links between Hong Kong and the Mainland.

In expanding the presence of Hong Kong financial institutions on the Mainland, following further discussions between the HKMA and the China Banking Regulatory Commission (CBRC), five new two-way measures in relation to the banking sector were added under the CEPA Supplement IV signed on 29 June 2007. In addition to benefiting Hong Kong banks through lower asset requirements for acquiring a shareholding in Mainland banks and fast-tracking the establishment of branches in selected areas of the Mainland, Mainland banks will be encouraged to establish a presence in Hong Kong.

As for facilitating outflows from the Mainland, further to the work of the four-party working group on offshore wealth management services provided by commercial banks on the Mainland, (comprising the HKMA, the CBRC, the State Administration of Foreign Exchange (SAFE) and the Securities and Futures Commission), the investment scope of the scheme was expanded in May 2007. This was followed by the implementation of other Qualified Domestic Institutional Investors schemes operated by fund managers, securities firms and insurance companies on the Mainland. In August, SAFE also announced a pilot scheme to allow Mainland residents to invest directly in overseas securities. Apart from developing Hong Kong as a platform for outflows from the Mainland, these arrangements are expected to help increase the breadth and depth of the market.

The issuance of renminbi bonds in Hong Kong in July was a key milestone in the development of renminbi business in Hong Kong. To facilitate the issuance and trading of renminbi bonds, Hong Kong's Real Time Gross Settlement system and the Central Moneymarkets Unit were upgraded to process the real-time transfers of renminbi funds and renminbi debt securities. The clearing agreements under the renminbi business scheme were also amended. By the end of the year, there were three issues of renminbi bonds, totalling RMB10 billion. The renminbi bond market in Hong Kong has created a new channel for financial intermediation between Hong Kong and the Mainland, providing a new renminbi-denominated investment instrument for depositors and banks in Hong Kong, and a new funding avenue for Mainland issuers.

At the end of 2007, renminbi deposits totalled RMB33.4 billion and the number of accounts exceeded 698,000. Thirty-seven, or almost all retail banks in Hong Kong, were offering renminbi banking services.

Strengthening research on Mainland economic and financial issues

Improving the understanding of economic and financial developments on the Mainland and their implications for Hong Kong as an international financial centre continued throughout the year. *China Economic Issues*, a dedicated research series introduced in 2006, continued to be a useful reference for monitoring and analysing Mainland economic and financial market issues with a significant

bearing on Hong Kong. Projects undertaken in 2007 included studying the impact of the renminbi exchange rate on Asian currencies; the high volatility of the A-share market; the price convergence between A- and H-shares; rural developments on the Mainland; and the profitability of Mainland urban commercial banks. With the increasing use of the renminbi outside Mainland China, a conference was held in October on the internationalisation of the currency. The participants discussed the related international experiences, reviewed the current external use of the renminbi and explored its potential as an international currency.

 > [Research](#) > [China Economic Issues](#)

Training

Training programmes for officials of the People's Bank of China and the CBRC in Hong Kong and on the Mainland continued to expand. The courses covered monetary policy, financial stability, banking supervision, compliance risk, accounting management, macroeconomic analysis and financial risk management, and prevention of money laundering. Sixteen courses, or 3,081 man-days of training, were provided to 1,401 Mainland officials.

The HKMA also provided training on request to other external parties, including courses for Mainland commercial banks, regulators in the region and a regional course on Operational Risk Management under the APEC financial regulators' training initiative. More than 400 participants attended these seminars in 2007, doubling the number in 2006.

PLANS FOR 2008 AND BEYOND

With the global financial environment expected to remain volatile in 2008, regional co-operation to improve financial stability and surveillance will be particularly important. The HKMA will continue to co-operate with other central banks to develop analytical tools to better monitor risks. Representation in central banking and international financial forums remains a priority and the HKMA will ensure Hong Kong's views and concerns are heard. The HKMA will pursue further upgrades of Hong Kong's credit ratings. These initiatives should serve to improve Hong Kong's leading position as an international financial centre in the region.

On Mainland financial co-operation, the HKMA will work closely with Mainland authorities on implementing the Action Agenda. The main focus of the work in 2008 is the strengthening of the links and interaction between the financial markets of the Mainland and Hong Kong, and the further expansion of Hong Kong's renminbi business. Monitoring of the economic, financial and monetary developments on the Mainland and understanding of their implications for Hong Kong will be further improved. The HKMA will also strengthen co-operation with Mainland regulators, and organise training seminars and courses for staff of Mainland authorities and other external parties.

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

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



Reserves Management

The Exchange Fund recorded an investment return of 11.8%, 126 basis points above the return on its investment benchmark in 2007. This was achieved in extremely volatile markets affected by the US sub-prime mortgage crisis and subsequent credit tightening.

THE EXCHANGE FUND

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

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives and benchmark

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

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

These objectives take full account of the statutory purposes of the Exchange Fund, and are incorporated into the investment benchmark of the Fund, which guides its long-term strategic asset allocation. Currently the bond-to-equity ratio of the benchmark is 77:23. In terms of currency mix, 88% of the benchmark is allocated to the US dollar bloc (which includes the Hong Kong dollar) and the remaining 12% to other currencies.

Having regard to the benchmark requirements, the Exchange Fund is managed under two distinct portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio holds highly liquid US dollar-denominated securities to provide full backing to the Monetary Base as required under the Currency Board arrangements. The Investment Portfolio is invested primarily in the bond and equity markets of the member countries of the Organisation for Economic Co-operation and Development to preserve the value and long-term purchasing power of the assets.

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

The investment process

The investment process of the Exchange Fund is underpinned by decisions on two types of asset allocation – the strategic asset allocation and the tactical asset allocation. The strategic asset allocation, reflected in the investment benchmark, represents the long-term optimal asset allocation given the investment objectives of the Exchange Fund. Guided by the strategic allocation, assets are tactically allocated in an attempt to outperform the benchmark and thereby achieve a positive active return, or alpha.¹ This often means the actual allocation is different from the benchmark, or strategic, allocation. The differences between the actual and the benchmark allocations are known as “tactical deviations”. While the benchmark and the limits for tactical deviations are determined by the Financial Secretary in consultation with EFAC, tactical decisions are made by the HKMA under delegated authority. Within the limits allowed for tactical deviating, portfolio managers may take positions to take advantage of short-term market movements.

Investment management

Direct Investment

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

Use of external managers

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

Expenditures relating to the use of external managers include management and custodian fees, transaction costs and withholding tax. They are determined by, among other things, market factors and fluctuate from year to year. Details of these expenditure items, including those related to portfolios managed internally by the HKMA, can be found in the Notes to the Financial Statements of the Exchange Fund.

Risk management and compliance

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

 [Monetary Stability > Exchange Fund](#)

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

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2007

Financial markets were extremely volatile during the year. As the inflation outlook for major economies generally heightened in the first half, markets expected tighter monetary policies, and global investors continued to seek higher investment returns in the asset markets. As a result, major stock markets performed well for most of the period before the summer and major government bond markets declined as interest rates rose.

The markets changed considerably during the summer with the onset of the credit crunch stemming from the US sub-prime mortgage crisis. From early 2007, the housing slowdown in the US caused a large number of defaults on sub-prime mortgages. As the values of the underlying properties of these mortgages fell, many banks with exposure to the sub-prime mortgage market incurred heavy losses. The risk appetite of investors declined sharply in the wake of reports of write-downs by banks. There was a shortage of liquidity in the market and short-term interbank rates rose substantially for long periods.

As investors shifted their investment to safer assets and the Federal Reserve cut its federal funds target rate three times by a total of 100 basis points starting in the autumn, key government bond yields declined from their recent peaks. In the stock markets, the S&P 500 and DAX indices declined by around 10% from mid-July to late August and, after rebounding in September following an interest rate cut by the Fed, dropped again in November as a result of investor concern. The year ended with slightly easier credit conditions, as major central banks co-operated to provide liquidity support to the market.

The US dollar weakened against all major currencies during the year. In June, the Japanese yen weakened to a recent low against the US dollar, as investors built up carry-trade positions. However, a reversal in market sentiment caused by the sub-prime mortgage crisis led to the unwinding of these positions, and by November the yen had strengthened by over 10%.

The performances of major bond, equity and currency markets in 2007 are shown in Table 1.

Table 1. 2007 market returns	
Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+10.9%
Yen	+6.7%
Bond markets	
Relevant US Government Bond (1-3 years) Index	+7.4%
Equity markets	
Standard & Poor's 500 Index	+3.5%
Hang Seng Index	+39.3%

The Exchange Fund's performance

The Exchange Fund earned a gross investment income of \$142.2 billion in 2007, comprising \$61 billion from bond investments, \$55.8 billion from Hong Kong equities, \$6.7 billion from foreign equities, and a foreign exchange revaluation gain of \$18.7 billion. The valuation gain and dividend income of the Strategic Portfolio amounted to \$4.7 billion, making a total return of \$146.9 billion. The total investment income represented an investment return of 11.8% [excluding the Strategic Portfolio], which was 126 basis points better than the return of the investment benchmark for the year.

Table 2 shows the annualised investment return of the Exchange Fund compared with the investment benchmark and domestic inflation from 1994 to 2007. The annual return of the Exchange Fund from 1994 to 2007 is set out in Chart 1. Since 1994, the Exchange Fund has generated a compounded annual return of 7.0%, which compares favourably with the compounded annual inflation rate of 1.5% over the period. The comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2007 is shown in Chart 2. Table 3 shows the currency mix of the Fund's assets on 31 December 2007.

[Press Releases > Exchange Fund](#)

Table 2. Gross investment return of the Exchange Fund in Hong Kong dollar terms¹

	Return on total assets	Return on investment benchmark ²	Alpha	CPI(A) ³
2007	11.8%	10.6%	+1.3%	+2.8%
2006	9.5%	8.9%	+0.6%	+1.9%
1999 – 2007 annualised	6.8%	5.6%	+1.2%	-0.5%
1994 – 2007 annualised	7.0%	N/A	N/A	+1.5%

¹ For the Annual Reports from 2001 to 2003, the return on total assets and return on investment benchmark are in US dollar terms.

² Established in January 1999.

³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 2004/2005 base new series.

Chart 1. Investment return of the Exchange Fund (1994-2007)

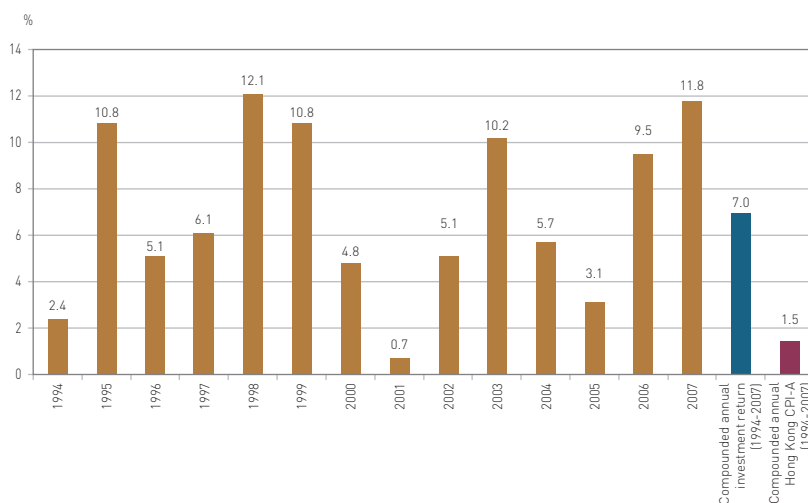
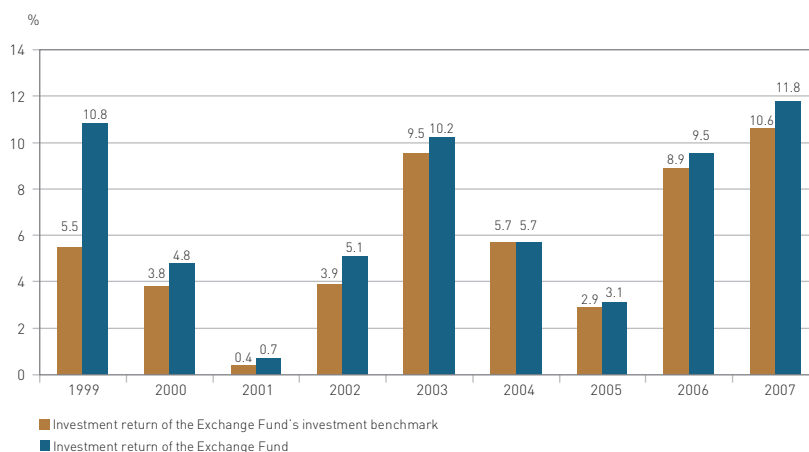


Chart 2. Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2007)**Table 3. Currency mix of the Exchange Fund's assets on 31 December 2007 – including forward transactions**

	HK\$ billion	%
US dollar bloc		
US dollar ¹	1,032.6	73.0
Hong Kong dollar	215.5	15.2
Non-US dollar bloc	166.3	11.8
Total	1,414.4	100.0

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



Professional and Corporate Services

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

THE HKMA IN THE COMMUNITY

The HKMA emphasises transparency and accessibility in its operations. Its work in this area is co-ordinated by the Corporate Development Division within the Corporate Services Department. The Division is responsible for providing media, publications, public communications and administrative services to the HKMA. It also provides translation and drafting services, and support to the Exchange Fund Advisory Committee (EFAC) and its Sub-Committees.

Media relations

The HKMA continues to maintain close ties with the media. In 2007, 13 stand-up media interviews were held and 64 media interviews were given by the HKMA. Senior staff of the HKMA met four overseas media delegations to discuss monetary and financial developments in Hong Kong. During the year the HKMA issued 287 press releases and handled an average of 42 press enquiries each day. A media briefing was organised in March 2007 to provide financial reporters with more information about the new investment-income sharing arrangement between the Exchange Fund and the fiscal reserves.



Chief Executive Joseph Yam at a stand-up interview.

Publications

The *HKMA Annual Report*, *Quarterly Bulletin* and *Monthly Statistical Bulletin* are the major sources of information on monetary, banking and economic issues in Hong Kong. The June and December issues of the *Quarterly Bulletin* include the HKMA's *Half-Yearly Monetary and Financial Stability Report*. The HKMA has published five background briefs introducing the HKMA and its work on maintaining monetary and banking stability. The latest one, published in 2007, explains how Hong Kong's official reserves are managed.

The *HKMA Annual Report 2006* won a Silver Award and a Citation for Achievement in Corporate Governance Disclosure in the Hong Kong Management Association's Best Annual Reports Award. The Report also won three prizes in the 2007 International Annual Report Competition Awards organised by the International Academy of Communications Arts and Sciences, Inc.

The HKMA website

The HKMA website www.hkma.gov.hk provides comprehensive and accessible news and information about the HKMA. All the main HKMA publications, together with a great deal of other information, are available on the website. More than 4,400 subscribers now receive the latest HKMA news through a daily e-mail news service. In 2007 the research publications of the HKMA were re-organised to make access by readers easier.

Public education programme

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

The Centre presents a survey of the history of money and banking in Hong Kong and the key policy objectives of the HKMA, and provides information on Hong Kong banknotes, Internet banking security and the payment systems of Hong Kong. Daily guided tours are organised for visitors. During 2007 the Centre received over 48,000 visitors and more than 500 guided tours were organised for schools and other groups. Over 200,000 people have now visited the Centre since it opened in December 2003.

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

In 2007, four public seminars on the Linked Exchange Rate system were organised for more than 3,000 students, teachers and members of the public. Since the launch of the education programme in 1998, more than 36,000 people have participated in the seminars. The HKMA sponsored an RTHK radio quiz programme on finance and economics in November and December, attracting more than 2,000 participants.

 [HKMA Information Centre](#)



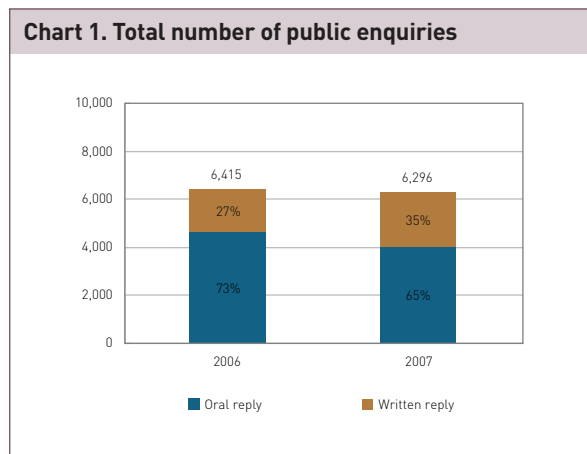
Education seminar on the Linked Exchange Rate system.



Chief Executive Joseph Yam presents prizes to Mr Raymond Yu Wing-cheung, overall winner of the radio quiz.

Public enquiries

The Public Enquiry Service (PES) of the HKMA received nearly 6,300 enquiries in 2007. The interactive voice response system used by the PES and the HKMA website provide basic information on the work of the HKMA. Over one-third of the public enquiries were related to banking issues. Other major topics included Hong Kong's monetary policy, the Exchange Fund, the issue of notes and coins and market infrastructure. Most of the written enquires came from law firms, researchers, academics and students in finance subjects, and overseas banks and regulators. The percentage of written enquires increased to 35% in 2007 from 27% in 2006 (Chart 1).



General administration

The HKMA continued to streamline its administrative work to improve cost-effectiveness. Contingency plans were kept under review and a number of drills were held, including a table-top exercise on handling an outbreak of influenza.

The HKMA has implemented an Environmental Policy since 2001 with the aim of conserving resources and promoting an environmentally friendly working environment. In 2007 consumption of paper declined by 16%, and recycled paper constituted 41% of the total used, up from 13% in 2006. Electricity consumption in the HKMA's offices decreased by 6.5% during the year.¹

The HKMA supports and encourages recycling. Regular charity campaigns are held to collect unwanted clothes, toys and other re-usable items from staff. Waste paper and used printer cartridges are collected for recycling. Obsolete computers and peripheral equipment are donated to charities for re-use. In recognition of the HKMA's commitment, the Hong Kong Council of Social Service presented "The Most Donation Campaign" award to the HKMA in June 2007.

During 2007 teams from the HKMA participated in a number of charity events, such as the Shenzhen Western Corridor Walk for Millions and the Raleigh Wilson Trail Challenge, in which the HKMA Team came first in the corporate category. Forty-seven staff participated in a blood donation drive organised by the Hong Kong Red Cross in May. Other charity events included the Dress Special Day and the Skip Lunch Day organised by the Community Chest.



HKMA staff participate in the Shenzhen Western Corridor Walk for Millions.

¹ Excluding the data centres, which house crucial IT facilities.

The HKMA Volunteer Team gave more than 300 hours of their free time in 2007 to voluntary services, participating in a fun day organised by the Chak Yan Centre, organising an outing with the senior citizens of the Ho Kwok Pui Chun Social Centre, and visiting the Tung Wah Group of Hospitals Fong Shu Chuen Day Care Centre. The HKMA procured office supplies from a workshop operated by people with disabilities. In recognition of the HKMA's commitment to corporate citizenship, the Hong Kong Council of Social Service awarded the Caring Organisation Logo to the HKMA.



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



HKMA volunteers visit the TWGHs Fong Shu Chuen Day Care Centre.

HUMAN RESOURCES

The HKMA is a compact organisation demanding specialised and high-quality skills from its staff. It needs to recruit, develop and maintain a professional and highly qualified workforce to carry out its policy objectives and respond flexibly to changing work priorities. The HKMA is an integral part of the Government but is empowered under the Exchange Fund Ordinance to employ staff on terms different from those of the civil service in order to attract personnel of the right experience and expertise. As a public organisation, the HKMA aims to maintain a lean and flexible structure and to redeploy staff resources to meet new and increased workload whenever possible.

Staffing in 2007

The establishment of the HKMA at the end of 2007 was 622. The quantity and complexity of the work carried out by the HKMA has continued to increase as a result of new and expanded responsibilities arising from an increasingly challenging financial environment requiring new approaches to supervision, investment and financial intermediation.

The HKMA regularly reviews the deployment of staff to achieve greater efficiency. Whenever possible, new demands are met by existing resources before creation of new posts is considered. For example, staff were redeployed to prepare for the implementation of Basel II. Additional workload generated from new projects, such as the Asian Bond Fund programme, was shouldered by existing staff in addition to existing work. Specialist banking supervisory teams were set up mainly through restructuring of existing teams to cope with the work arising from the increasingly complex and innovative financial environment.

同心展關懷

caringorganisation²⁰⁰⁶⁻⁰⁸

Awarded by The Hong Kong Council of Social Service
香港社會服務聯會頒發

The HKMA seconded staff to other organisations such as the International Monetary Fund to help co-ordinate activities or policy initiatives in which Hong Kong has an interest. A number of staff are redeployed on a full-time or part-time basis to provide operational support to the Hong Kong Deposit Protection Board and the Treasury Markets Association.

Sixteen new posts were added to the establishment in January 2008, an increase of 2.6%, to ensure that the HKMA has sufficient staff resources to carry out its policy objectives in the following main areas:

- maintenance of Hong Kong's status as an international financial centre through the implementation of the Action Agenda proposed by the Focus Group on Financial Services under the Economic Summit on "China's 11th Five-Year Plan and the Development of Hong Kong"
- specialised supervision of banking activities and risk areas
- more complex investment approaches for the Exchange Fund
- a greater focus on risk management, requiring additional surveillance, research, and business continuity planning
- increased participation in international forums and provision of technical assistance to other organisations.

 > Careers@HKMA

Organisational and senior staff changes in 2007

With the implementation of Basel II on 1 January 2007, the Internal Ratings-based Validation Team was redeployed from the Banking Policy Department to the Banking Supervision Department in September. The number of divisions in the Banking Policy Department decreased from four to three through streamlining.

In early 2008, as a result of the reorganisation of the Monetary Management and Infrastructure Department and the Strategy and Risk Department, two new departments were formed: the Financial Infrastructure Department (FID) and the Monetary Management Department (MMD). The FID comprises two divisions, the Financial Infrastructure Development Division (the former Market Systems Development Division) and the new Payment Systems Operation Division; while the MMD includes the Monetary Operations Division and the Support Services Division. The reorganisation helped the HKMA focus on the implementation of infrastructural projects key to maintaining Hong Kong as an international financial centre.

The former Deputy Chief Executive (Monetary), Mr Y K Choi, took up the post of Deputy Chief Executive (Banking) on 1 September 2007, responsible for the full range of banking policy, development and supervision work, when the position was vacated following the departure of Mr William Ryback at the end of August 2007. Mr Eddie Yue was promoted to Deputy Chief Executive (Monetary) to replace Mr Choi, overseeing the work on monetary management, financial infrastructure, reserves management, and strategy and risk. The Executive Director post vacated by Mr Yue was temporarily taken over by Mr Edmond Lau in addition to his own duties. Table 1 gives a breakdown of the establishment and strength of the HKMA.

Professional and Corporate Services

Department	Functions	Senior staff		Others	
		Establishment	Strength	Establishment	Strength
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	6	6
Banking Development	To formulate policies for the development of the banking industry, and to facilitate settlement for transactions executed by the HKMA for the Exchange Fund.	1	1	66	61
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	40	39
Banking Supervision	To supervise day-to-day operations of authorized institutions.	1	1	156	151
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through active participation in the international central banking and financial community.	1	1	51	44
Monetary Management & Infrastructure	To maintain currency stability through monitoring of market operations and development issues and developing financial market infrastructure.	1	1	40	35
Research	To conduct research and analysis on economic and international financial market development, both in Hong Kong and in other economies.	1	1	35	31
Reserves Management	To manage reserves to achieve investment returns in line with established guidelines and to enhance the quality of return by diversifying into different investment markets and asset types.	1	1	54	50
Strategy & Risk	To examine and develop strategic responses to the impact on the HKMA's policies and operations of such processes as the globalisation and liberalisation of financial markets and technological change, and to ensure adequate supply of banknotes and coins.	1	0	11	9
Office of the General Counsel	To provide in-house legal support and advice.	1	1	15	15
Corporate Services	To provide support services in the form of administrative, finance, human resources, IT, and secretariat services, and to handle media and community relations.	1	1	142	141
Internal Audit	To provide audit services through assisting the management in controlling risks, monitoring compliance, and improving the efficiency of internal control systems and procedures.	0	0	8	8
Total		14	13	624	590

Remuneration policies and pay review mechanism

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

Pay for HKMA staff is reviewed annually by the Financial Secretary on the advice of EFAC and the GSC, taking into account the findings of independent consultants on pay trends and pay levels in the financial sector, the GSC's assessment of the performance of the HKMA, and other factors considered appropriate. The performance of individual staff members is taken into account in distributing any approved overall pay awards.

Remuneration of senior staff

The remuneration packages of the senior staff in 2007 are shown in Table 2.

Table 2. Remuneration packages of HKMA senior staff in 2007			
	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
\$'000			
Number of staff	1	4	11
Fixed pay	7,181	4,537	3,021
Variable pay	2,741	1,387	639
Other benefits	415	509	318
Notes:			
(1) Except for annual leave accrued, the actual remuneration received by staff not serving a full year is annualised for the purpose of calculating the average annual package for the rank.			
(2) The number of staff in this table at the Deputy Chief Executive (DCE) and Executive Director (ED) ranks reflects staff movement during the year and includes, among the EDs, the Chief Executive Officer (CEO) of the Hong Kong Mortgage Corporation. The established number of posts at the DCE level is three and the ED level is eleven (including the CEO of the Hong Kong Mortgage Corporation): please see the organisation chart on page 33 for details.			
(3) Other benefits include provident funds or gratuity as the case may be, medical and life insurance and annual leave accrued during the year. The provision of these benefits varies among senior staff depending on individual terms of service.			

Training and development

The HKMA accords priority to staff training and development because it believes a motivated and professional team is the organisation's most valuable asset. In 2007, 2,667 training days were provided, including 960 days of training in general skills and 1,707 days of training in job-specific skills. Each staff member received an average of 4.46 days of training during the year.

Two central banking courses were arranged, one for new staff and one for non-managerial staff. A tailor-made three-week induction course was provided for the new assistant managers in the banking departments. Regular briefings and workshops on various banking topics were conducted by in-house experts for staff in the banking departments.

With the assistance of external consultants and institutions, the HKMA organised a number of training courses for staff on general skills, including management, language, presentation and communication. HKMA staff also participated in training courses organised by the Government, other central banks, multilateral organisations and other institutions. Three senior staff participated in advanced management workshops, and two attended advanced national studies programmes in Beijing designed for senior government officials of Hong Kong.

The HKMA plans to increase training in specialised areas and on complex financial products. We also intend to develop more systematic training plans to cater for the needs of individual ranks.

As part of the staff development programme, and to facilitate communication between management and staff, the senior staff conducted regular briefings and discussion sessions with staff on topical issues and subjects related to the work of the HKMA. A number of informal gatherings were also organised during the year.

FINANCE

The Finance Division aims to achieve an efficient allocation of resources within the HKMA and to adhere to the HKMA's policy of transparency in financial reporting.

The HKMA's administration budget is prepared annually to ensure that sufficient resources are available for carrying out its functions. Budgeting takes into account both the continuing operations of the HKMA and its strategic development set out in a three-year plan approved by the Financial Secretary on the advice of EFAC. During the process, departments are required to assess their needs for the coming year and to consider where savings in staffing and expenditure can be achieved. This requires departments to critically assess each year the value of existing services and the cost-effectiveness of different methods of delivering them. The Finance Division scrutinises all budget requests and discusses with individual departments before submitting a consolidated

draft budget for scrutiny by the senior management.

The GSC of EFAC then deliberates on the budget and recommends any changes it believes are necessary, before putting it through EFAC to the Financial Secretary for his approval.

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

The administrative expenditure in 2007 and the budgeted expenditure for 2008 are shown in Table 3. The difference between the 2007 and 2008 budgets arises mainly from an increase in staff costs, reflecting full-year effects of staff increases and pay adjustments in 2007, the 2008 pay adjustment, and the increase of 16 posts approved for 2008 by the Financial Secretary on the advice of EFAC.

\$ million	2007 Budget*	2007 Actual	2008 Budget*
Staff costs	572		638
Salaries and other staff costs		528	
Retirement benefit costs		30	
Premises expenses			
Operating lease charges	4	4	5
Other premises expenses (including utility charges and management fees)	32	31	34
General operating costs			
Maintenance of office and computer equipment	33	31	33
Financial information and communication services (including trading, dealing terminals and data link charges)	32	28	34
External relations (including international meetings)	21	15	25
Professional and other services	20	15	17
Training	4	4	6
Others	5	4	5
Total HKMA administrative expenditure	723	690	797

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

Table 4. Additional expenses (2007 and 2008 budgeted)

\$ million	2007 Budget*	2007 Actual	2008 Budget*
Subsidy to the Hong Kong Institute for Monetary Research	13	13	16
Premises expenses of international financial organisations in Hong Kong	20	19	26
Service fees for financial infrastructure	48	29	46

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

Expenditure has also increased in relation to the continuing programme to upgrade Hong Kong's financial infrastructure, including the migration of the Real Time Gross Settlement systems and the Central Moneymarkets Unit (CMU) from the existing proprietary platform to SWIFTNet. Spending on financial infrastructure is not related to the HKMA's own operations, but to providing and expanding payment and other systems to enable markets to function efficiently. Expenses related to premises for international organisations in Hong Kong also increased owing to the full-year effect of the expansion of these international organisations during 2007, reflecting and supporting Hong Kong's status as an international financial centre. These expenses are shown in Table 4. The HKMA also provides operational support to the Hong Kong Deposit Protection Board in the areas of investment, accounting and settlement on a cost-recovery basis endorsed by the Financial Secretary. The reimbursement received from the Board is included in the "other income" of the Exchange Fund.

In addition to investment income from managing the Exchange Fund, the HKMA earns revenue mainly through licence fees paid by AIs, rental payments from tenants in Two International Finance Centre, and custodian and transaction fees from users of the CMU. In 2007 the HKMA also received reimbursement of \$12.9 million from the Hong Kong Deposit Protection Board for providing operational support to the Board according to Section 6 of the Deposit Protection Scheme Ordinance. In 2008 licence fees are estimated at \$132 million (2007: \$132 million) and the other income components (excluding investment income) at \$74 million (2007: \$58 million).

The HKMA adopts best practices in financial disclosure as far as these are consistent with central banking operations. These standards include the reporting requirements laid down by the International Monetary Fund's Special Data Dissemination Standard. In the absence of specific reporting requirements applicable to central banking institutions, the HKMA adopts the disclosure requirements applicable to commercial entities as far as possible in order to achieve a high level of transparency. Working with the auditors and other accounting professionals, the Finance Division prepares and presents the group accounts in accordance with the Hong Kong Financial Reporting Standards in as far as these are applicable to central banking operations. In this regard, the *HKMA Annual Report* compares favourably with those of other central banking institutions and monetary authorities. It contains detailed disclosure and thorough analyses of a wide range of expense items and budgetary information. Detailed information relating to the investment management of the Exchange Fund can be found in the Reserves Management chapter, while information on the expenditure relating to investment management is shown in the Notes to the Financial Statements.

INFORMATION TECHNOLOGY

In 2007 the IT division continued the preparatory work for upgrading the Lotus Notes email system and the SWIFTNet migration project. The Division helped conduct tests and rehearsals on the payout system of the Deposit Protection Scheme to ensure its readiness, and upgraded the information system used by the Banking Supervision Department in anticipation of new banking returns to be launched following the implementation of Basel II.

In November, an annual organisation-wide drill on the business continuity plan was conducted to ensure the continuous provision of reliable and efficient IT services in an emergency. All IT services were found to meet the targets set by the business units.

SETTLEMENT SERVICES

The Settlement Section supports the reserves management, monetary operations and other activities of the HKMA requiring transfers of funds or assets of the Exchange Fund, and is also responsible for ensuring that the settlement standards adopted by the HKMA are in line with the best market practice. It also provides professional advice to other departments of the HKMA on projects that have implications for settlement functions.

The Settlement Section reports to one of the Division Heads and the Executive Director of the Banking Development Department. Since the Banking Department is separated from the monetary operations of the HKMA, this arrangement achieves a segregation of duties and helps avoid potential conflicts of interest.

OFFICE OF THE GENERAL COUNSEL

The Office of the General Counsel is responsible for providing legal advice to the HKMA with regard to all aspects of its work. There are nine lawyers in the Office, providing a full range of legal services to different departments. They participate in meetings and conferences for central bankers and the banking industry, concerning such issues as prevention of money laundering, risk management and crisis management. They also take part in video conferences with their counterparts in other central banks to discuss topics of legal concern.

INTERNAL AUDIT

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

The Division continued to operate independently and effectively in 2007. Co-ordinated by the Division, line management of all business units updated their risk assessment reports, which identify and assess risks and corresponding controls in their operations. Based on the risk profiles of individual business units, the Division prepared an audit plan covering all the significant risks. The Division also analysed the results of the assessments to facilitate review by the Risk Committee.

Internal audit assignments carried out by the Division covered reserves management, monetary operations, monitoring and supervision of the clearing systems, operations of the CMU, finance and settlement, security and backup arrangements of critical IT systems and business continuity planning. The Division advised on IT systems development projects and performed special reviews at the request of senior management. The Division also reviewed the operations of the Hong Kong Deposit Protection Board and Hong Kong Note Printing Limited. Results of the audits conducted in 2007 were satisfactory. Recommendations for improvement put forward by the Division were accepted and implemented by management.

The Division attaches great importance to keeping abreast of the development of the internal auditing standards in the industry and the practices adopted by other central banks. In 2007 the Division sent staff to attend an international conference organised for heads of internal audit of central banks and monetary authorities by the Bank for International Settlements. Meetings were held with the internal auditors of other central banks from time to time to exchange views and share experience in risk management and internal auditing issues. Training courses and seminars on risk management, audit techniques, management and language skills were arranged for staff of the Division.

 > Internal Audit

RISK MANAGEMENT

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

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

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

The Committee meets regularly to review the risk assessments made by the business units and the adequacy of controls, and to identify potential or emerging risks and devise mitigating strategies. One of the areas on which the Committee focused in 2007 was contingency planning for unauthorised smelting of legal tender coins in the event of any substantial surge in the metal value of the coins. The Committee also reviewed and strengthened the back-up-site policy of the HKMA.

The Exchange Fund

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

Report of the Director of Audit



Audit Commission **The Government of the Hong Kong Special Administrative Region**

Independent Audit Report

To the Financial Secretary

I certify that I have audited the financial statements of the Exchange Fund set out on pages 118 to 193, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2007, 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 (cont.)

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 2007 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

26 March 2008

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

Exchange Fund

Exchange Fund - Income and Expenditure Account

for the year ended 31 December 2007

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2007	2006	2007	2006
INCOME					
Interest income		47,567	43,483	45,222	41,184
Dividend income		7,036	6,162	7,266	6,429
Net realised and revaluation gains		75,833	38,799	75,717	38,806
Net exchange gains		18,729	17,360	18,713	17,338
Investment income	4(a)	149,165	105,804	146,918	103,757
Bank licence fees		132	132	132	132
Other income		295	277	75	64
TOTAL INCOME		149,592	106,213	147,125	103,953
EXPENDITURE					
Interest expense	4(b)	(37,058)	(38,996)	(35,370)	(37,421)
Operating expenses	4(c)	(2,445)	(1,986)	(2,260)	(1,810)
Note and coin expenses	4(d)	(223)	(160)	(223)	(160)
Write back of impairment losses on loans		5	8	-	-
TOTAL EXPENDITURE		(39,721)	(41,134)	(37,853)	(39,391)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATE					
		109,871	65,079	109,272	64,562
Share of profit of associate, net of tax		8	8	-	-
SURPLUS BEFORE TAXATION					
		109,879	65,087	109,272	64,562
Income tax		(86)	(86)	-	-
SURPLUS FOR THE YEAR					
		109,793	65,001	109,272	64,562
ATTRIBUTABLE TO:					
Owner of the Fund		109,779	64,987	109,272	64,562
Minority interests		14	14	-	-
		109,793	65,001	109,272	64,562

The notes on pages 123 to 193 form part of these financial statements.

Exchange Fund - Balance Sheet

as at 31 December 2007

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2007	2006	2007	2006
ASSETS					
Cash and money at call	6	21,310	19,726	21,222	19,661
Placements with banks and other financial institutions	7	114,343	44,670	111,695	42,766
Derivative financial instruments	8(a)	3,786	1,490	3,129	1,227
Financial assets designated at fair value through profit or loss	9	1,253,442	1,088,192	1,253,442	1,088,192
Available-for-sale securities	10	4,531	5,107	493	493
Held-to-maturity securities	11	5,607	4,753	-	-
Loan portfolio	12	34,460	32,376	-	-
Gold	13	436	330	436	330
Other assets	14	19,664	18,944	18,329	17,949
Investments in subsidiaries	15	-	-	2,145	2,145
Interest in associate	16	43	35	-	-
Property, plant and equipment	17(a)	816	853	595	611
Operating land lease prepayment	18	2,923	2,997	2,923	2,997
Intangible assets	19	13	22	13	22
TOTAL ASSETS		1,461,374	1,219,495	1,414,422	1,176,393
LIABILITIES AND EQUITY					
Certificates of Indebtedness	20	163,381	156,926	163,381	156,926
Government-issued currency notes and coins in circulation	20	7,545	6,842	7,545	6,842
Balance of the banking system	21	10,639	2,035	10,639	2,035
Derivative financial instruments	8(a)	733	735	610	572
Trading liabilities	22	-	2,096	-	2,096
Placements by banks and other financial institutions	23	-	7,572	-	7,572
Placements by other Hong Kong Special Administrative Region government funds	24	464,585	324,530	464,585	324,530
Placements by Hong Kong statutory bodies		30	26	30	26
Exchange Fund Bills and Notes issued	25	141,767	129,139	141,767	129,139
Other debt securities issued	26	33,291	28,910	-	-
Mortgage-backed securities issued	27	4,229	5,341	-	-
Other liabilities	28	14,277	44,231	8,885	38,947
Total liabilities		840,477	708,383	797,442	668,685
Accumulated surplus	29	620,592	510,813	616,980	507,708
Revaluation reserve	29	126	125	-	-
Total equity attributable to owner of the Fund		620,718	510,938	616,980	507,708
Minority interests	29	179	174	-	-
Total equity		620,897	511,112	616,980	507,708
TOTAL LIABILITIES AND EQUITY		1,461,374	1,219,495	1,414,422	1,176,393

Joseph Yam

Monetary Authority
26 March 2008

The notes on pages 123 to 193 form part of these financial statements.

Exchange Fund

Exchange Fund - Statement of Changes in Equity

for the year ended 31 December 2007

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2007	2006	2007	2006
Total equity at 1 January		511,112	446,098	507,708	443,146
Net income recognised directly in equity					
Available-for-sale securities					
– changes in fair value	29	18	31	–	–
– transfer to income and expenditure account on disposal	29	(22)	–	–	–
Cash flow hedges					
– changes in fair value	29	5	–	–	–
Net income for the year recognised directly in equity		1	31	–	–
Surplus for the year	29	109,793	65,001	109,272	64,562
Total recognised income and expenditure for the year		109,794	65,032	109,272	64,562
Attributable to:					
– owner of the Fund		109,780	65,018	109,272	64,562
– minority interests		14	14	–	–
Dividends paid to minority interests	29	(9)	(18)	–	–
Total equity at 31 December	29	620,897	511,112	616,980	507,708

The notes on pages 123 to 193 form part of these financial statements.

Exchange Fund - Cash Flow Statement

for the year ended 31 December 2007

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2007	2006	2007	2006
Cash flows from operating activities					
Surplus before share of profit of associate		109,871	65,079	109,272	64,562
Adjustments for:					
Interest income	4(a)	(47,567)	(43,483)	(45,222)	(41,184)
Dividend income	4(a)	(7,036)	(6,162)	(7,266)	(6,429)
Net (gains)/losses on available-for-sale securities	4(a)	18	(19)	-	-
Interest expense	4(b)	37,058	38,996	35,370	37,421
Depreciation and amortisation	4(c)	149	149	116	117
Elimination of exchange differences and other non-cash items		(1,511)	(1,701)	(1,419)	(1,587)
Interest received		46,208	41,755	44,000	39,705
Interest paid		(65,967)	(20,090)	(64,401)	(18,606)
Dividends received		7,054	6,149	7,037	6,133
Income tax paid		(86)	(63)	-	-
		78,191	80,610	77,487	80,132
Change in fair value of derivatives and other debt securities issued		(1,922)	727	(1,848)	683
Change in placements with banks and other financial institutions		713	(1,723)	755	(1,535)
Change in financial assets designated at fair value through profit or loss		(129,170)	(225,220)	(129,170)	(225,220)
Change in loan portfolio		(2,074)	1,204	-	-
Change in gold		(106)	(64)	(106)	(64)
Change in other assets		618	(186)	807	(298)
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		7,158	8,691	7,158	8,691
Change in balance of the banking system		8,604	474	8,604	474
Change in trading liabilities		(2,096)	(5,316)	(2,096)	(5,316)
Change in placements by banks and other financial institutions		(7,572)	(18,140)	(7,572)	(18,140)
Change in placements by other Hong Kong Special Administrative Region government funds		140,055	27,444	140,055	27,444
Change in placements by Hong Kong statutory bodies		4	26	4	26
Change in Exchange Fund Bills and Notes issued		12,628	11,005	12,628	11,005
Change in other liabilities		(1,058)	1,763	(1,044)	1,989
Net cash from/(used in) operating activities		103,973	(118,705)	105,662	(120,129)

Exchange Fund - Cash Flow Statement (cont.)

for the year ended 31 December 2007

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2007	2006	2007	2006
Cash flows from investing activities					
Proceeds from sale or redemption of available-for-sale securities		24,138	18,602	-	-
Purchase of available-for-sale securities		(23,477)	(21,051)	-	-
Proceeds from redemption of held-to-maturity securities		3,242	229	-	-
Purchase of held-to-maturity securities		(4,081)	(397)	-	-
Purchase of property, plant and equipment and intangible assets		(29)	(29)	(17)	(18)
Dividends received from subsidiaries		-	-	261	272
Net cash from/(used in) investing activities		(207)	(2,646)	244	254
Cash flows from financing activities					
Proceeds from issue of other debt securities		16,356	13,202	-	-
Redemption of other debt securities issued		(12,341)	(12,699)	-	-
Proceeds from issue of mortgage-backed securities		-	2,000	-	-
Redemption of mortgage-backed securities issued		(1,144)	(1,830)	-	-
Dividends paid to minority interests		(9)	(18)	-	-
Net cash from/(used in) financing activities		2,862	655	-	-
Net increase/(decrease) in cash and cash equivalents		106,628	(120,696)	105,906	(119,875)
Cash and cash equivalents at 1 January		99,437	218,541	97,665	215,953
Effect of foreign exchange rate changes		1,422	1,592	1,419	1,587
Cash and cash equivalents at 31 December	30	207,487	99,437	204,990	97,665

The notes on pages 123 to 193 form part of these financial statements.

Exchange Fund - Notes to the Financial Statements

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

1 PRINCIPAL ACTIVITIES

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund (the Fund), manages the Fund in accordance with the provisions of the Exchange Fund Ordinance. 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 three distinct portfolios: the Backing Portfolio, the Investment Portfolio and the Strategic Portfolio. The assets of the Backing Portfolio fully match the Monetary Base, under Hong Kong's Currency Board system. The Strategic Portfolio was established in 2007 to hold financial assets which are to be held on a longer term. 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 to the Financial Statements (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 expenditure. The estimates and associated assumptions are based on experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

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

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

2.3 Subsidiaries

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

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

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

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 to the Financial Statements (cont.)

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

2.4 Associate

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

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 and financial liabilities 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. Other financial assets and financial liabilities are recognised using settlement date accounting.

Exchange Fund - Notes to the Financial Statements (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 Group through a subsidiary, The Hong Kong Mortgage Corporation Limited (HKMC), which contain embedded derivatives that significantly modify the cash flows that would otherwise be required under the contracts.

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

2.5.2.3 Loans and receivables

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

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

2.5.2.4 Held-to-maturity securities

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

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

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

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

2.5.2.6 Other financial liabilities

Other financial liabilities are financial liabilities other than trading liabilities and those designated at fair value 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 Group through the HKMC.

Exchange Fund - Notes to the Financial Statements (cont.)

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

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

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.

Exchange Fund - Notes to the Financial Statements (cont.)

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

2.5.4 Derecognition

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

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

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

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.

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 assesses and documents whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows 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.

Exchange Fund - Notes to the Financial Statements (cont.)

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

2.8.1 Fair value hedge

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

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.

2.8.2 Cash flow hedge

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

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

When a 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 cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is ultimately recognised in the income and expenditure account. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income and expenditure account.

Exchange Fund - Notes to the Financial Statements (cont.)

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

2.9 Impairment of financial assets

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

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

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

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.

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.

Exchange Fund - Notes to the Financial Statements (cont.)

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

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

Prior to 1 April 2007, interest on the majority of the placements by other HKSAR government funds was payable at rates determined by reference to the investment income of the Fund. Interest on these placements was recognised monthly in the income and expenditure account on an accrual basis, based on the investment income of the Fund for the month.

With effect from 1 April 2007, interest on the majority of the placements by other HKSAR government funds is payable at a fixed rate determined annually (note 24). Interest on these placements is recognised daily in the income and expenditure account on an accrual basis, using the effective interest method.

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

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 in the period in which they arise.

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 to the Financial Statements (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:

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

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

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

2.19 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 including the Strategic Portfolio; and
- maintaining the stability and integrity of monetary and financial systems of Hong Kong, which includes banking supervision and monetary management, and the activities of the 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.

There have been no significant changes to the accounting policies applied in these financial statements for the years presented as a result of these developments. However, as a result of the adoption of HKFRS 7, Financial Instruments: Disclosures, the financial statements include expanded disclosure about the significance of the Group's financial instruments and the nature and extent of risks arising from those instruments, compared with the information previously required to be disclosed by HKAS 32, Financial Instruments: Disclosure and Presentation. These disclosures are provided throughout these financial statements, in particular in note 36.

HKFRS 7 does not have any material impact on the classification, recognition and measurement of the amounts recognised in the financial statements.

The Group has not applied any new standard that is not yet effective for the current accounting period (see note 39).

Exchange Fund - Notes to the Financial Statements (cont.)

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

4 INCOME AND EXPENDITURE**(a) Investment income**

	Group		Fund	
	2007	2006	2007	2006
Interest income				
– from derivative financial instruments	134	189	134	189
– from financial assets designated at fair value through profit or loss	37,516	35,059	37,516	35,059
– from other financial assets	9,917	8,235	7,572	5,936
	47,567	43,483	45,222	41,184
Dividend income				
– from financial assets designated at fair value through profit or loss	6,994	6,134	6,994	6,134
– from other financial assets	42	28	13	12
– from subsidiaries	-	-	259	283
	7,036	6,162	7,266	6,429
Net realised and revaluation gains/(losses)				
– on derivative financial instruments	2,809	1,875	2,323	1,500
– on financial assets and financial liabilities designated at fair value through profit or loss	73,042	36,905	73,394	37,306
– on available-for-sale securities	(18)	19	-	-
	75,833	38,799	75,717	38,806
Net exchange gains	18,729	17,360	18,713	17,338
TOTAL INVESTMENT INCOME	149,165	105,804	146,918	103,757

Exchange Fund - Notes to the Financial Statements (cont.)

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

(b) Interest expense

	Group		Fund	
	2007	2006	2007	2006
Interest expense on derivative financial instruments	8	3	8	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	5,082	5,119	4,902	5,033
Interest expense on other financial liabilities	31,968	33,874	30,460	32,385
TOTAL	37,058	38,996	35,370	37,421
Comprises:				
Interest on placements by other HKSAR government funds				
– at rates determined by reference to the investment income of the Fund	6,354	28,936	6,354	28,936
– at a fixed rate determined annually	21,261	–	21,261	–
– at market-based rates	77	203	77	203
Interest on Exchange Fund Bills and Notes issued	4,898	4,934	4,898	4,934
Other interest expense	4,468	4,923	2,780	3,348
	37,058	38,996	35,370	37,421

Exchange Fund - Notes to the Financial Statements (cont.)

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

(c) Operating expenses

	Group		Fund	
	2007	2006	2007	2006
Staff costs				
Salaries and other staff costs	645	582	528	479
Retirement benefit costs	37	33	30	27
Premises and equipment expenses				
Depreciation and amortisation	149	149	116	117
Rental expenses under operating leases	21	4	21	4
Other premises expenses	40	38	33	32
General operating costs				
Maintenance of office and computer equipment	38	37	31	32
Financial information and communication services	33	32	28	27
External relations	16	15	15	14
Service fees for financial infrastructure	29	28	29	28
Other professional services	24	27	15	15
Training	5	5	4	4
Others	13	12	17	11
Investment management and custodian fees				
Management and custodian fees	882	699	882	699
Transaction costs	293	172	291	168
Withholding tax	203	146	203	146
Others	17	7	17	7
TOTAL	2,445	1,986	2,260	1,810

Exchange Fund - Notes to the Financial Statements (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 were as follows:

	Group	
	2007	2006
Fixed pay	53.1	50.4
Variable pay	14.4	12.8
Other benefits	5.5	5.0
	73.0	68.2

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

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

HK\$	Group	
	2007	2006
500,000 or below	–	1
3,000,001 to 3,500,000	1	4
3,500,001 to 4,000,000	4	6
4,000,001 to 4,500,000	5	1
4,500,001 to 5,000,000	1	–
5,000,001 to 5,500,000	1	–
5,500,001 to 6,000,000	–	1
6,000,001 to 6,500,000	1	2
6,500,001 to 7,000,000	1	–
9,500,001 to 10,000,000	–	1
10,000,001 to 10,500,000	1	–
	15	16

(d) Note and coin expenses

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

5 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

	Notes	Group - 2007						
		Total	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	21,310	-	-	21,310	-	-	-
Placements with banks and other financial institutions	7	114,343	-	-	114,343	-	-	-
Derivative financial instruments	8(a)	3,786	3,786	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9	1,253,442	-	1,253,442	-	-	-	-
Available-for-sale securities	10	4,531	-	-	-	-	4,531	-
Held-to-maturity securities	11	5,607	-	-	-	5,607	-	-
Loan portfolio	12	34,460	-	-	34,460	-	-	-
Other assets	14	19,664	-	-	19,664	-	-	-
FINANCIAL ASSETS		1,457,143	3,786	1,253,442	189,777	5,607	4,531	-
Certificates of Indebtedness	20	163,381	-	-	-	-	-	163,381
Government-issued currency notes and coins in circulation	20	7,545	-	-	-	-	-	7,545
Balance of the banking system	21	10,639	-	-	-	-	-	10,639
Derivative financial instruments	8(a)	733	733	-	-	-	-	-
Placements by other HKSAR government funds	24	464,585	-	-	-	-	-	464,585
Placements by Hong Kong statutory bodies		30	-	-	-	-	-	30
Exchange Fund Bills and Notes issued	25	141,767	-	141,767	-	-	-	-
Other debt securities issued	26	33,291	-	4,971	-	-	-	28,320
Mortgage-backed securities issued	27	4,229	-	-	-	-	-	4,229
Other liabilities	28	14,277	-	-	-	-	-	14,277
FINANCIAL LIABILITIES		840,477	733	146,738	-	-	-	693,006

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Notes	Total	Group-2006		Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
			Trading financial instruments (including hedging instruments)	Financial assets and liabilities designated at fair value through profit or loss				
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	32,376	-	-	32,376	-	-	-
Other assets	14	18,944	-	-	18,944	-	-	-
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	-	-	-	-	-	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 to the Financial Statements (cont.)

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

	Notes	Fund - 2007						
		Total	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	21,222	-	-	21,222	-	-	-
Placements with banks and other financial institutions	7	111,695	-	-	111,695	-	-	-
Derivative financial instruments	8(a)	3,129	3,129	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9	1,253,442	-	1,253,442	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Other assets	14	18,329	-	-	18,329	-	-	-
FINANCIAL ASSETS		1,408,310	3,129	1,253,442	151,246	-	493	-
Certificates of Indebtedness	20	163,381	-	-	-	-	-	163,381
Government-issued currency notes and coins in circulation	20	7,545	-	-	-	-	-	7,545
Balance of the banking system	21	10,639	-	-	-	-	-	10,639
Derivative financial instruments	8(a)	610	610	-	-	-	-	-
Placements by other HKSAR government funds	24	464,585	-	-	-	-	-	464,585
Placements by Hong Kong statutory bodies		30	-	-	-	-	-	30
Exchange Fund Bills and Notes issued	25	141,767	-	141,767	-	-	-	-
Other liabilities	28	8,885	-	-	-	-	-	8,885
FINANCIAL LIABILITIES		797,442	610	141,767	-	-	-	655,065

Exchange Fund - Notes to the Financial Statements (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	-	-	-	-	-	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 to the Financial Statements (cont.)

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

6 CASH AND MONEY AT CALL

	Group		Fund	
	2007	2006	2007	2006
At amortised cost				
Balance with central banks	836	691	836	691
Balance with banks	20,474	19,035	20,386	18,970
TOTAL	21,310	19,726	21,222	19,661

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2007	2006	2007	2006
At amortised cost				
Placements in respect of reverse repurchase agreements				
– with central banks	1,992	1,988	1,992	1,988
– with banks and other financial institutions	5,537	4,518	5,537	4,518
Other placements with banks	106,814	38,164	104,166	36,260
TOTAL	114,343	44,670	111,695	42,766

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

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

Exchange Fund - Notes to the Financial Statements (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			
	2007		2006		2007		2006	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	529	120	389	56	338	-	344	8
Currency derivatives								
Forward foreign exchange contracts	2,718	477	880	557	2,718	477	880	535
Others								
Stock index futures contracts	73	132	2	29	73	132	2	29
Bond futures contracts	-	1	1	-	-	1	1	-
	3,320	730	1,272	642	3,129	610	1,227	572
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	451	3	218	93	-	-	-	-
Currency derivatives								
Currency swap contracts	7	-	-	-	-	-	-	-
	458	3	218	93	-	-	-	-
Derivatives designated as hedging instruments in cash flow hedges								
Currency derivatives								
Currency swap contracts	8	-	-	-	-	-	-	-
TOTAL	3,786	733	1,490	735	3,129	610	1,227	572

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

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

Exchange Fund - Notes to the Financial Statements (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									
	2007					2006				
	Total	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total	Up to 3 months	3-12 months	1-5 years	Over 5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	58,452	11,127	22,920	21,495	2,910	57,153	16,118	19,369	16,814	4,852
Currency derivatives										
Forward foreign exchange contracts	161,915	161,857	58	-	-	179,967	174,970	4,997	-	-
Others										
Stock index futures contracts	22,790	22,790	-	-	-	13,502	13,502	-	-	-
Bond futures contracts	2,141	2,141	-	-	-	2,065	2,065	-	-	-
	245,298	197,915	22,978	21,495	2,910	252,687	206,655	24,366	16,814	4,852
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	25,799	1,575	6,717	14,518	2,989	25,199	3,793	4,099	14,932	2,375
Currency derivatives										
Currency swap contracts	691	-	425	266	-	425	-	-	425	-
	26,490	1,575	7,142	14,784	2,989	25,624	3,793	4,099	15,357	2,375
Derivatives designated as hedging instruments in cash flow hedges										
Currency derivatives										
Currency swap contracts	5,460	-	-	-	5,460	-	-	-	-	-
TOTAL	277,248	199,490	30,120	36,279	11,359	278,311	210,448	28,465	32,171	7,227

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Fund									
	Notional amounts with remaining life of									
	Total	2007				2006				
Up to 3 months		3-12 months	1-5 years	Over 5 years	Total	Up to 3 months	3-12 months	1-5 years	Over 5 years	
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	7,739	500	900	4,339	2,000	7,400	500	1,500	2,400	3,000
Currency derivatives										
Forward foreign exchange contracts	161,857	161,857	-	-	-	164,157	164,143	14	-	-
Others										
Stock index futures contracts	22,790	22,790	-	-	-	13,502	13,502	-	-	-
Bond futures contracts	2,141	2,141	-	-	-	2,065	2,065	-	-	-
TOTAL	194,527	187,288	900	4,339	2,000	187,124	180,210	1,514	2,400	3,000

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

At fair value	Group and Fund	
	2007	2006
Debt securities		
Treasury bills and commercial paper		
Listed outside Hong Kong	-	289
Unlisted	136,767	140,000
Certificates of deposit		
Unlisted	6,236	20,050
Other debt securities		
Listed		
- in Hong Kong	-	182
- outside Hong Kong	343,356	292,732
Unlisted	436,523	375,107
Total debt securities	922,882	828,360
Equity securities		
Listed		
- in Hong Kong	184,569	122,445
- outside Hong Kong	145,991	137,387
Total equity securities	330,560	259,832
TOTAL	1,253,442	1,088,192

Exchange Fund - Notes to the Financial Statements (cont.)

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

10 AVAILABLE-FOR-SALE SECURITIES

	Group		Fund	
	2007	2006	2007	2006
Debt securities, at fair value				
Listed				
– in Hong Kong	462	163	–	–
– outside Hong Kong	128	283	–	–
Unlisted	2,666	3,626	–	–
	3,256	4,072	–	–
Equity securities				
Listed in Hong Kong, at fair value	782	542	–	–
Unlisted, at cost	493	493	493	493
TOTAL	4,531	5,107	493	493

The Group's investment in unlisted equity securities at 31 December 2007 represents a holding of 4,285 shares (2006: 4,285 shares) in the Bank for International Settlements (also see note 34) 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 value is made.

11 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2007	2006	2007	2006
At amortised cost				
Debt securities				
Listed				
– in Hong Kong	620	586	–	–
– outside Hong Kong	757	1,012	–	–
Unlisted	4,230	3,155	–	–
TOTAL	5,607	4,753	–	–

Exchange Fund - Notes to the Financial Statements (cont.)

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

12 LOAN PORTFOLIO

	Group		Fund	
	2007	2006	2007	2006
Mortgage loans, at amortised cost	32,669	31,109	-	-
Non-mortgage loans, at amortised cost	1,805	1,291	-	-
Allowance for loan impairment	(14)	(24)	-	-
TOTAL	34,460	32,376	-	-

13 GOLD

	Group and Fund	
	2007	2006
Gold, at market value		
66,798 ounces (2006: 66,798 ounces)	436	330

14 OTHER ASSETS

	Group		Fund	
	2007	2006	2007	2006
Interest and dividends receivable	11,891	10,553	11,164	9,977
Prepayments, receivables and other assets	1,579	4,691	971	4,272
Unsettled sales and redemption of securities	5,895	3,427	5,895	3,427
Staff housing loans	299	273	299	273
TOTAL	19,664	18,944	18,329	17,949

Exchange Fund - Notes to the Financial Statements (cont.)

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

15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2007	2006
Unlisted shares, at cost	2,145	2,145

The following is a list of the principal subsidiaries as at 31 December 2007 and 2006:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	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 (2006: HK\$1 billion), which is callable from the Fund.

16 INTEREST IN ASSOCIATE

	Group		Fund	
	2007	2006	2007	2006
Unlisted shares, at cost	-	-	-	-
Share of net assets	43	35	-	-
TOTAL	43	35	-	-

Investment in associate comprises unlisted shares of Hong Kong Interbank Clearing Limited directly held by the Fund at a cost of HK\$5,000 (2006: HK\$5,000). Details of the associate are as follows:

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

Exchange Fund - Notes to the Financial Statements (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 2006	621	612	1,233
Additions	1	26	27
Disposals	–	(3)	(3)
At 31 December 2006	622	635	1,257
At 1 January 2007	622	635	1,257
Additions	2	24	26
Disposals	–	(20)	(20)
At 31 December 2007	624	639	1,263
Accumulated depreciation			
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
At 1 January 2007	46	358	404
Charge for the year	15	48	63
Written back on disposal	–	(20)	(20)
At 31 December 2007	61	386	447
Net book value			
At 31 December 2007	563	253	816
At 31 December 2006	576	277	853

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Fund		
	Premises	Plant and equipment	Total
Cost			
At 1 January 2006	612	197	809
Additions	–	16	16
Disposals	–	(2)	(2)
At 31 December 2006	612	211	823
At 1 January 2007	612	211	823
Additions	–	14	14
Disposals	–	(16)	(16)
At 31 December 2007	612	209	821
Accumulated depreciation			
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
At 1 January 2007	44	168	212
Charge for the year	14	16	30
Written back on disposal	–	(16)	(16)
At 31 December 2007	58	168	226
Net book value			
At 31 December 2007	554	41	595
At 31 December 2006	568	43	611

(b) The net book value of premises comprises:

	Group		Fund	
	2007	2006	2007	2006
In Hong Kong				
Buildings situated on land held on medium-term leases (between 10 and 50 years)	539	552	530	544
Outside Hong Kong				
Freehold land and the building situated thereon	24	24	24	24
TOTAL	563	576	554	568

Exchange Fund - Notes to the Financial Statements (cont.)

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

18 OPERATING LAND LEASE PREPAYMENT

	Group and Fund	
	2007	2006
Cost		
At 1 January and 31 December	3,231	3,231
Accumulated amortisation		
At 1 January	234	160
Charge for the year	74	74
At 31 December	308	234
Net book value		
At 31 December	2,923	2,997

19 INTANGIBLE ASSETS

	Group and Fund	
	Computer software licences and system development costs	
	2007	2006
Cost		
At 1 January	234	232
Additions	3	2
At 31 December	237	234
Accumulated amortisation		
At 1 January	212	199
Charge for the year	12	13
At 31 December	224	212
Net book value		
At 31 December	13	22

Exchange Fund - Notes to the Financial Statements (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	
	2007	2006	2007	2006
Carrying amount	163,381	156,926	7,545	6,842
Reconciliation with face value:				
Hong Kong dollar face value	HK\$163,435	HK\$157,385	HK\$7,547	HK\$6,862
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\$20,953	US\$20,178	US\$968	US\$880
Market exchange rate for translation into Hong Kong dollars	US\$1=HK\$7.7974	US\$1=HK\$7.77725	US\$1=HK\$7.7974	US\$1=HK\$7.77725
Carrying amount	HK\$163,381	HK\$156,926	HK\$7,545	HK\$6,842

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 Hong Kong Monetary Authority (HKMA) for the account of the Fund. The aggregate amount in these clearing accounts, which must not have a negative balance, represents the total level of liquidity in the interbank market.

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

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

22 TRADING LIABILITIES

	Group and Fund	
	2007	2006
At fair value		
Short positions in Exchange Fund Bills and Notes (note 25)	-	2,096

23 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2007	2006
At amortised cost		
Placements by banks	-	7,572

Exchange Fund - Notes to the Financial Statements (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	
	2007	2006
Placements with interest payable at rates determined by reference to the investment income of the Fund		
General Revenue Account	-	114,840
Land Fund	-	128,560
Capital Works Reserve Fund	-	51,811
Civil Service Pension Reserve Fund	-	15,814
Disaster Relief Fund	-	28
Innovation and Technology Fund	-	4,081
Lotteries Fund	-	4,870
	-	320,004
Placements with interest payable at a fixed rate determined annually		
General Revenue Account	216,956	-
Land Fund	150,467	-
Capital Works Reserve Fund	65,069	-
Civil Service Pension Reserve Fund	18,509	-
Disaster Relief Fund	16	-
Innovation and Technology Fund	4,474	-
Lotteries Fund	6,062	-
Capital Investment Fund	1,221	-
Loan Fund	1,483	-
	464,257	-
Placements with interest payable at market-based rates		
General Revenue Account	269	264
Capital Investment Fund	-	765
Loan Fund	16	2,909
Capital Works Reserve Fund	43	356
Innovation and Technology Fund	-	80
Lotteries Fund	-	152
	328	4,526
TOTAL	464,585	324,530

Prior to 1 April 2007, interest on the majority of the placements by other HKSAR government funds was payable at rates determined by reference to the investment income of the Fund.

Exchange Fund - Notes to the Financial Statements (cont.)

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

With effect from 1 April 2007, the income-sharing arrangement for such placements was replaced by a new fixed rate scheme. A fixed rate determined every January is applied to calculate the interest payable on such placements. The rate is the average investment return of the Fund's Investment Portfolio for the past six years or the average annual yield of three-year Exchange Fund Notes for the previous year, whichever is the higher. This rate was fixed at 7 per cent per annum for 2007 and has been fixed at 9.4 per cent for 2008.

Placements by other HKSAR government funds are not permanently appropriated for the use of the Fund, and the majority are repayable on demand.

25 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group and Fund	
	2007	2006
At fair value		
Exchange Fund Bills and Notes issued		
Exchange Fund Bills	76,206	69,526
Exchange Fund Notes	66,399	62,587
	142,605	132,113
Exchange Fund Bills and Notes held		
Exchange Fund Bills	(500)	(2,066)
Exchange Fund Notes	(338)	(908)
	(838)	(2,974)
TOTAL	141,767	129,139

EFBN issued are unsecured obligations of the Fund and are one of the components of the Monetary Base in the Currency Board Account. Exchange Fund Bills are issued by the Fund for maturities not exceeding one year. Exchange Fund Notes are issued by the Fund with 2-year, 3-year, 5-year, 7-year, 10-year and 15-year maturities. EFBN issued are valued at offer prices derived from 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 2007, there were no short positions in EFBN (2006: HK\$2,096 million) (note 22).

Exchange Fund - Notes to the Financial Statements (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			
	2007		2006	
	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Issued by Currency Board Operations segment				
Redemption amount at 1 January	70,088	61,700	70,009	56,700
Issuance	210,787	17,000	201,015	17,600
Redemption	(204,263)	(14,400)	(200,936)	(12,600)
Redemption amount at 31 December	76,612	64,300	70,088	61,700
Long positions held by Financial Stability and Other Activities segment				
Redemption amount at 31 December	(500)	(331)	(2,069)	(877)
Total redemption amount	76,112	63,969	68,019	60,823
Carrying amount, at fair value	75,706	66,061	67,460	61,679
Difference	406	(2,092)	559	(856)

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

26 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2007	2006	2007	2006
Debt securities issued, carried at amortised cost				
Notes	3,948	3,849	-	-
Debt securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk				
Notes	24,372	22,080	-	-
	28,320	25,929	-	-
Debt securities issued, designated at fair value through profit or loss				
Notes	4,971	2,981	-	-
TOTAL	33,291	28,910	-	-

Exchange Fund - Notes to the Financial Statements (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	
	2007	2006	2007	2006
Total debt securities issued				
Redemption amount at 1 January	28,867	28,243	-	-
Issuance	16,412	13,323	-	-
Redemption	(12,341)	(12,699)	-	-
Redemption amount at 31 December	32,938	28,867	-	-
Carrying amount	33,291	28,910	-	-
Difference	(353)	(43)	-	-
Debt securities issued, designated at fair value through profit or loss				
Redemption amount	5,015	3,069	-	-
Carrying amount, at fair value	4,971	2,981	-	-
Difference	44	88	-	-

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	
	2007	2006	2007	2006
Mortgage-backed securities issued, carried at amortised cost	1,663	2,127	-	-
Mortgage-backed securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk	2,566	3,214	-	-
TOTAL	4,229	5,341	-	-

Exchange Fund - Notes to the Financial Statements (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	
	2007	2006	2007	2006
Total mortgage-backed securities issued				
Redemption amount at 1 January	5,347	5,177	-	-
Issuance	-	2,000	-	-
Redemption	(1,144)	(1,830)	-	-
Redemption amount at 31 December	4,203	5,347	-	-
Carrying amount	4,229	5,341	-	-
Difference	(26)	6	-	-

28 OTHER LIABILITIES

	Group		Fund	
	2007	2006	2007	2006
Interest payable on placements by other HKSAR government funds				
– at rates determined by reference to the investment income of the Fund	-	28,936	-	28,936
– at market-based rates	-	13	-	13
	-	28,949	-	28,949
Other interest payable	924	871	452	521
Unsettled purchases of securities	7,912	9,149	7,912	9,149
Accrued charges and other liabilities	5,356	5,177	521	328
Tax payable	22	20	-	-
Deferred tax liabilities	63	65	-	-
TOTAL	14,277	44,231	8,885	38,947

Exchange Fund - Notes to the Financial Statements (cont.)

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

29 EQUITY

	Group		Fund	
	2007	2006	2007	2006
Attributable to owner of the Fund				
Accumulated surplus				
At 1 January	510,813	445,826	507,708	443,146
Surplus for the year	109,779	64,987	109,272	64,562
At 31 December	620,592	510,813	616,980	507,708
Revaluation reserve				
At 1 January	125	94	-	-
Net fair value gains, net of tax				
- on available-for-sale securities	18	31	-	-
- on cash flow hedges	5	-	-	-
Net gains transferred to income and expenditure account on disposal				
- on available-for-sale securities	(22)	-	-	-
At 31 December	126	125	-	-
	620,718	510,938	616,980	507,708
Minority interests				
At 1 January	174	178	-	-
Surplus for the year	14	14	-	-
Dividends paid to minority interests	(9)	(18)	-	-
At 31 December	179	174	-	-
TOTAL	620,897	511,112	616,980	507,708

Exchange Fund - Notes to the Financial Statements (cont.)

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

30 NOTES TO THE CASH FLOW STATEMENT**Analysis of cash and cash equivalents in the cash flow statement**

	Group		Fund	
	2007	2006	2007	2006
Cash and money at call	21,310	19,726	21,222	19,661
Placements with banks and other financial institutions	113,324	42,938	110,915	41,231
Treasury bills and commercial paper	68,955	34,943	68,955	34,943
Certificates of deposit	3,898	1,830	3,898	1,830
TOTAL	207,487	99,437	204,990	97,665

Reconciliation with the balance sheet

	Notes	Group		Fund	
		2007	2006	2007	2006
Amounts shown in the balance sheet					
Cash and money at call	6	21,310	19,726	21,222	19,661
Placements with banks and other financial institutions	7	114,343	44,670	111,695	42,766
Financial assets designated at fair value through profit or loss					
Treasury bills and commercial paper	9	136,767	140,289	136,767	140,289
Certificates of deposit	9	6,236	20,050	6,236	20,050
		278,656	224,735	275,920	222,766
Less: Amounts with original maturity beyond 3 months		(71,169)	(125,298)	(70,930)	(125,101)
Cash and cash equivalents in the cash flow statement		207,487	99,437	204,990	97,665

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 including the Strategic Portfolio; and
- maintaining the stability and integrity of monetary and financial systems of Hong Kong, which includes banking supervision and monetary management, and the activities of the subsidiaries.

Exchange Fund - Notes to the Financial Statements (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	
	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006
Income	22,181	13,462	123,386	89,643	145,567	103,105	4,025	3,108	149,592	106,213
Expenditure										
Interest expense	4,902	4,936	30,457	32,385	35,359	37,321	1,699	1,675	37,058	38,996
Other expenses (note 31(b))	-	-	-	-	1,499	1,118	1,164	1,020	2,663	2,138
	4,902	4,936	30,457	32,385	36,858	38,439	2,863	2,695	39,721	41,134
Surplus before share of profit of associate	17,279	8,526	92,929	57,258	108,709	64,666	1,162	413	109,871	65,079
Share of profit of associate	-	-	-	-	-	-	8	8	8	8
Surplus before taxation	17,279	8,526	92,929	57,258	108,709	64,666	1,170	421	109,879	65,087
Income tax	-	-	-	-	-	-	(86)	(86)	(86)	(86)
Surplus for the year	17,279	8,526	92,929	57,258	108,709	64,666	1,084	335	109,793	65,001
Attributable to:										
Owner of the Fund	17,279	8,526	92,929	57,258	108,709	64,666	1,070	321	109,779	64,987
Minority interests	-	-	-	-	-	-	14	14	14	14
	17,279	8,526	92,929	57,258	108,709	64,666	1,084	335	109,793	65,001

Exchange Fund - Notes to the Financial Statements (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	
	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006
Assets												
Backing Assets												
Investment in designated												
US dollar assets	355,174	328,567	-	-	355,174	328,567	-	-	-	-	355,174	328,567
Interest receivable on												
designated US dollar assets	2,226	1,963	-	-	2,226	1,963	-	-	-	-	2,226	1,963
Net accounts receivable	-	2,143	-	-	-	2,143	-	-	-	1	-	2,144
Other investments	-	-	1,018,591	821,411	1,018,591	821,411	61,245	47,455	(838)	(2,244)	1,078,998	866,622
Other assets	-	-	14,416	14,422	14,416	14,422	6,115	5,588	4,445	189	24,976	20,199
TOTAL ASSETS	357,400	332,673	1,033,007	835,833	1,390,407	1,168,506	67,360	53,043	3,607	(2,054)	1,461,374	1,219,495
Liabilities												
Monetary Base												
Certificates of Indebtedness	163,381	156,926	-	-	163,381	156,926	-	-	-	-	163,381	156,926
Government-issued currency notes and coins in circulation	7,545	6,842	-	-	7,545	6,842	-	-	-	-	7,545	6,842
Balance of the banking system	10,639	2,035	-	-	10,639	2,035	-	-	-	-	10,639	2,035
Exchange Fund Bills and Notes issued	142,605	132,113	-	-	142,605	132,113	-	-	(838)	(2,974)	141,767	129,139
Interest payable on												
Exchange Fund Notes	462	467	-	-	462	467	-	-	-	-	462	467
Net accounts (receivable)/ payable	(4,445)	(911)	-	-	(4,445)	(911)	-	-	4,445	919	-	8
Other debt securities issued	-	-	-	-	-	-	33,291	28,910	-	-	33,291	28,910
Mortgage-backed securities issued	-	-	-	-	-	-	4,229	5,341	-	-	4,229	5,341
Placements by banks and other financial institutions	-	-	-	7,572	-	7,572	-	-	-	-	-	7,572
Placements by other HKSAR government funds	-	-	464,585	324,530	464,585	324,530	-	-	-	-	464,585	324,530
Placements by Hong Kong statutory bodies	-	-	-	-	-	-	30	26	-	-	30	26
Other liabilities	-	-	8,940	38,979	8,940	38,979	5,608	7,607	-	1	14,548	46,587
Total Liabilities	320,187	297,472	473,525	371,081	793,712	668,553	43,158	41,884	3,607	(2,054)	840,477	708,383
Accumulated surplus												
At 1 January	35,201	33,811	464,752	401,372	499,953	435,183	10,860	10,643	-	-	510,813	445,826
Surplus for the year attributable to owner of the Fund	17,279	8,526	92,929	57,258	108,709	64,666	1,070	321	-	-	109,779	64,987
Transfer between Currency Board Operations and general reserves (note 31(e))	(15,267)	(7,136)	1,801	6,122	(11,967)	104	11,967	(104)	-	-	-	-
At 31 December	37,213	35,201	559,482	464,752	596,695	499,953	23,897	10,860	-	-	620,592	510,813
Revaluation reserve	-	-	-	-	-	-	126	125	-	-	126	125
Minority interests	-	-	-	-	-	-	179	174	-	-	179	174
Total equity	37,213	35,201	559,482	464,752	596,695	499,953	24,202	11,159	-	-	620,897	511,112
TOTAL LIABILITIES AND EQUITY	357,400	332,673	1,033,007	835,833	1,390,407	1,168,506	67,360	53,043	3,607	(2,054)	1,461,374	1,219,495

Exchange Fund - Notes to the Financial Statements (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 2007, deduction from the Backing Assets comprises:

- "other liabilities" of Nil (2006: HK\$1 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 2007, deductions from the Monetary Base comprise:

- "other assets" of HK\$4,445 million (2006: HK\$189 million), consisting of two components:
 - (i) 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 (2006: HK\$3 million) and revaluation gains of HK\$209 million (2006: HK\$186 million) on these interest rate swaps are included in "net accounts receivable" to reduce the Monetary Base; and
 - (ii) EFBN issued on tender date but not yet settled of HK\$4,233 million (2006: Nil) are included in "net accounts receivable" to reduce the Monetary Base; and
- "other investments" of Nil (2006: HK\$730 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.

Exchange Fund - Notes to the Financial Statements (cont.)

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

- (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.

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.

	Notes	Group		Fund	
		2007	2006	2007	2006
Secured liabilities					
Stock index futures contracts –					
notional amount	8(b)	22,790	13,502	22,790	13,502
Bond futures contracts – notional amount	8(b)	2,141	2,065	2,141	2,065
Mortgage-backed securities issued	27	4,229	5,341	–	–
Assets pledged					
Financial assets designated at fair value					
through profit or loss		1,777	905	1,777	905
Held-to-maturity securities		106	–	–	–
Placements with banks		310	384	–	–
Mortgage loans		3,722	4,878	–	–

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

These transactions are conducted under terms that are usual and customary to standard lending, and securities borrowing and lending activities.

Exchange Fund - Notes to the Financial Statements (cont.)

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

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	
	2007	2006	2007	2006
Authorised but not yet contracted for	79	39	64	27

(b) Credit facility to the International Monetary Fund

The Fund has participated in the New Arrangements to Borrow (NAB), a standby credit facility provided to the International Monetary Fund (IMF) for the purpose of managing instability in the international monetary system. At 31 December 2007, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$4,189 million equivalent (2006: HK\$3,978 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2007, there was no outstanding balance due from the IMF under this NAB facility (2006: Nil).

(c) Credit facility to the Hong Kong Deposit Protection Board

The Fund has provided the Hong Kong Deposit Protection Board (HKDPB) with a standby credit facility of HK\$40 billion at prevailing market interest rates for meeting the necessary liquidity required for payment of compensation in the event of a bank failure. As at 31 December 2007, there was no outstanding balance due from the HKDPB under this facility (2006: Nil).

(d) Credit facility to The Hong Kong Mortgage Corporation Limited

The Fund has provided the HKMC with a revolving credit facility of HK\$10 billion at prevailing market interest rates. As at 31 December 2007, there was no outstanding balance due from the HKMC under this facility (2006: Nil).

(e) Repurchase agreements with other central banks

The Fund has entered into bilateral repurchase agreements with various central banks in Asia and Australasia amounting up to HK\$44,835 million equivalent (2006: HK\$44,719 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2007, there was no outstanding transaction with any central bank under this arrangement (2006: Nil).

Exchange Fund - Notes to the Financial Statements (cont.)

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

(f) Lease commitments

At 31 December 2007, the total future minimum lease payments under non-cancellable operating leases of premises were payable as follows:

	Group and Fund	
	2007	2006
Not later than one year	26	3
Later than one year and not later than five years	101	4
Later than five years	9	3
TOTAL	136	10

34 CONTINGENT LIABILITIES

At 31 December 2007, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$198 million equivalent (2006: 16.1 million Special Drawing Rights or HK\$188 million equivalent), in respect of the uncalled portion of its 4,285 shares (2006: 4,285 shares) in the Bank for International Settlements (note 10).

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, during the year, the Group, through the HKMC, purchased HK\$64 million (2006: HK\$107 million) of mortgage loans from the HKSAR Government.

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

36 FINANCIAL RISK MANAGEMENT

This note presents information about the nature and extent of risks to which the Group is exposed, in particular those arising from financial instruments, and the risk management framework of the Group. The principal financial risks the Group is exposed to are credit risk, market risk and liquidity risk.

36.1 Governance

The Financial Secretary is advised by EFAC in his control of the 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 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 (ISC) monitors the HKMA's investment management activities and makes recommendations on the investment policy and strategy of the Fund and on risk management and other related matters. Operating within the policies and guidelines endorsed by EFAC, the Reserves Management Department of the HKMA 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 to the Financial Statements (cont.)

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

As at 31 December 2007 and 2006, the Fund's asset allocation and currency mix set out in the investment benchmark were as follows:

	2007 and 2006
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.

The Risk Management and Compliance Division (RMC) of the Reserves Management Department is responsible for risk management and compliance monitoring regarding the investments of the Fund. RMC monitors the risk exposure of the Fund, checks compliance of investment activities against established guidelines and reports and follows up any identified breaches.

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.3 Credit risk

Credit risk is the risk of financial loss when a counterparty or a borrower fails to meet its contractual obligations. It arises principally from the investments of the Fund.

36.3.1 Management of credit risk

The HKMA maintains effective credit risk management over the investments of the Fund. Based on the delegated authority of EFAC, the Credit Review and Compliance Committee (CRCC) was established within the HKMA with the following responsibilities: (i) to establish and maintain the Credit Exposure Policy to govern the investments of the Fund; (ii) to review the adequacy of the existing credit risk management practices and, where necessary, formulate proposals for amendments; (iii) to conduct analysis of credit risk issues; (iv) to establish and review credit limits for the approved issuers and counterparties; and (v) to monitor the compliance of the investments of the Fund with the established policies and limits, and report and follow up any identified breaches. The CRCC is chaired by Deputy Chief Executive (Monetary) whose responsibilities are independent of the day-to-day investment activities of the Fund, and includes representatives from both the Reserves Management Department and the Monetary Management and Infrastructure Department of the HKMA.

Credit limits are established in accordance with in-house methodologies as set out in the Exchange Fund Investment Policy and Credit Exposure Policy to control the exposures to counterparty, issuer and country risks arising from the investments of the Fund.

(a) Counterparty risk

The Fund selects its counterparties in lending, placement, derivatives and trading transactions prudently and objectively. Since the Fund will conduct transactions with a counterparty for a range of financial instruments, credit limits are established to control the overall exposure to each authorised counterparty based on its credit ratings, financial strength, the size of its total assets and capital, and other relevant information.

Counterparty credit exposures are measured according to the risk nature of financial products involved in the transaction. Counterparty credit exposures of derivatives include an estimate for the potential future credit exposure of the derivative contracts, in addition to their positive mark-to-market replacement value.

Exchange Fund - Notes to the Financial Statements (cont.)

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

(b) Issuer risk

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

Moreover, to qualify as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Fund.

(c) Country risk

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

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

Any breaches of credit limits are reported to the CRCC, the ISC and EFAC, and are followed up by RMC in a timely manner. The approval authorities to sanction these breaches are set out in the Credit Exposure Policy.

To manage the exposure to credit risk arising from the loan portfolio and mortgage insurance business, a four-pronged approach is established for (i) selecting Approved Sellers carefully, (ii) adopting prudent mortgage purchasing criteria and insurance eligibility criteria, (iii) conducting effective due diligence reviews and (iv) ensuring adequate protection for higher-risk mortgages.

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.3.2 Exposure to credit risk

The maximum exposure to credit risk at the balance sheet date without taking account of any collateral held or other credit enhancements is shown below:

	Notes	Group		Fund	
		2007	2006	2007	2006
Cash and money at call	6	21,310	19,726	21,222	19,661
Placements with banks and other financial institutions	7	114,343	44,670	111,695	42,766
Derivative financial instruments	8(a)	3,786	1,490	3,129	1,227
Debt securities designated at fair value through profit or loss	9	922,882	828,360	922,882	828,360
Available-for-sale debt securities	10	3,256	4,072	-	-
Held-to-maturity securities	11	5,607	4,753	-	-
Loan portfolio	12	34,460	32,376	-	-
Other assets	14	19,664	18,944	18,329	17,949
Mortgage insurance risk in force	36.6	8,683	8,139	-	-
Loan commitments and other credit related commitments		89,024	88,697	99,024	98,697
TOTAL		1,223,015	1,051,227	1,176,281	1,008,660

The loan portfolio is secured by mortgages on properties. Reserve funds and deferred considerations are also used as an additional form of credit enhancement.

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.3.3 Credit quality

The Group predominantly invests in liquid Organisation for Economic Co-operation and Development (OECD) government bonds and other quasi-government debt securities issues. As at 31 December 2007, approximately 92% (2006: 90%) of the debt securities held by the Group were rated "triple-A" by Moody's or Standard and Poor's. The credit quality of major financial assets is analysed below:

	Group		Fund	
	2007	2006	2007	2006
Cash and money at call, placements with banks and other financial institutions, by credit rating¹				
AAA	2,788	3,170	2,788	2,634
AA-to AA +	85,411	35,478	84,370	34,059
A-to A +	46,025	11,016	44,330	11,010
Lower than A- (including un-rated risk)	1,429	14,732	1,429	14,724
	135,653	64,396	132,917	62,427
Debt securities, by credit rating¹				
AAA	857,148	751,587	855,674	749,717
AA-to AA +	16,530	33,604	9,394	26,854
A-to A +	13,909	20,870	13,656	20,665
Lower than A- (including un-rated risk)	44,158	31,124	44,158	31,124
	931,745	837,185	922,882	828,360
Loan portfolio				
Neither past due nor impaired (note (a))	33,191	30,121	-	-
Past due but not impaired (note (b))	1,243	2,209	-	-
Impaired (note (c))	40	70	-	-
Allowance for loan impairment	(14)	(24)	-	-
	34,460	32,376	-	-
TOTAL	1,101,858	933,957	1,055,799	890,787

¹ the lower of ratings designated by rating agencies Moody's and Standard and Poor's

Exchange Fund - Notes to the Financial Statements (cont.)

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

(a) Loans that are neither past due nor impaired

An internal rating system is used for assessing the credit quality of the loan portfolio. Grades 1 to 5 are loans that are neither past due nor impaired. Grades 1 to 3 include loans with no past due experience and with different level of credit enhancement in addition to the collateral. Grade 4 includes loans with past due experience and credit enhancement in addition to the collateral. Grade 5 includes loans with past due experience and collateral but without further credit enhancement. The following analysis shows the credit quality of loans that were neither past due nor impaired at the balance sheet date:

	Group		Fund	
	2007	2006	2007	2006
Grades				
1 to 3	33,142	30,067	-	-
4	8	8	-	-
5	41	46	-	-
TOTAL	33,191	30,121	-	-

(b) Loans that are past due but not impaired

These are loans where contractual interest or principal payments are past due but the Group believes that recognising an impairment loss is not appropriate on the basis of the level of collateral held. The following analysis shows the loans that were past due but not impaired at the balance sheet date:

	Group		Fund	
	2007	2006	2007	2006
Loans that were past due				
90 days or less	1,226	2,178	-	-
91 – 180 days	12	24	-	-
over 180 days	5	7	-	-
TOTAL	1,243	2,209	-	-
Fair value of collateral and other credit enhancements	2,858	3,959	-	-

Exchange Fund - Notes to the Financial Statements (cont.)

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

(c) Impaired loans

These are loans where the Group determines on an individual basis that it is probable that it will be unable to collect all principal and interest due according to the contractual terms of the loan agreements. At 31 December 2007, the fair value of related collateral held and credit enhancement was HK\$51 million (2006: HK\$73 million).

36.3.4 Concentration of credit risk

The Group has no significant concentration of credit risk. Credit risk of the Group is spread over a large number of counterparties and countries. The following table analyses the maximum credit risk exposure (see note 36.3.2) by industry groups:

	Group		Fund	
	2007	2006	2007	2006
Governments and government agencies ¹	881,745	779,694	881,399	779,349
Supra-nationals	35,901	37,161	35,794	37,081
States, provinces and public-sector entities ²	43,576	45,049	42,557	43,624
Financial institutions	149,997	93,339	140,567	86,106
Others	111,796	95,984	75,964	62,500
TOTAL	1,223,015	1,051,227	1,176,281	1,008,660

¹ including debt securities guaranteed by governments

² including debt securities guaranteed by states

36.4 Market risk

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

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.4.1 Types of market risk

(a) Interest rate risk

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

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

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

(b) Currency risk

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

Due to the linked exchange rate of the US dollar relative to the Hong Kong dollar, the Group's currency risk principally arises from its assets and liabilities denominated in foreign currencies other than the US dollar.

(c) Equity price risk

Equity price risk is the risk of loss arising from changes in equity prices. The Group's equity investments are subject to equity price risk since the value of these investments will decline if equity prices fall.

Majority of the equity securities held by the Group are constituent stocks of major stock market indexes and companies with large market capitalisation.

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.4.2 Management of market risk

The market risk of the Fund as a whole is regularly measured and monitored to prevent excessive risk exposure. The investment benchmark and tactical deviation limits of the Fund govern the asset allocation strategies. This, together with the volatility of asset markets, will affect the Fund's market risk exposure. The Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies. The market risk of the Fund is mainly measured and monitored using the Value-at-Risk (VaR) methodology.

VaR is calculated using the parametric approach based on a 95% confidence level and one-month time horizon. The result represents the maximum expected loss of the Fund over a one-month period under normal market conditions, with a 5% chance that the actual loss may exceed the calculated VaR. The Fund's absolute VaR and the relative VaR (i.e. the VaR of the Fund relative to its investment benchmark), expressed in dollar amounts, are measured by RMC and reported to management, ISC and EFAC on a regular basis.

The relative VaR of the Fund is also used to calculate the actual tracking error of the Fund against its investment benchmark. This is regularly monitored against the tracking error limit endorsed by EFAC to ensure that the market risk exposure of the Fund is within its limits. The tracking error of a portfolio indicates how well the portfolio tracks its investment benchmark. The smaller the tracking error, the better the portfolio tracks its benchmark. The tracking error limit is established to prevent the Fund from taking unduly large market risk with respect to its investment benchmark. The actual tracking error of the Fund is regularly reported to ISC and EFAC, and any breach of the limit is followed up in a timely manner.

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

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

In addition, to manage the interest rate risk arising from the fixed-rate debt securities issued by the Group to fund the purchase of portfolios of loans, a major portion of the risk is hedged using fair value hedges in the form of interest rate swaps by swapping into floating-rate funding to better match the floating-rate assets.

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.4.3 Exposure to market risk

(a) Interest rate risk

The following tables show the interest rate gap position in respect of the Group's major interest bearing assets and liabilities, including the net repricing effect of interest rate derivatives. The assets and liabilities are stated at carrying amounts and categorised by the earlier of contractual repricing dates or maturity dates.

	Group-2007 Repricing period						Interest bearing total	Non- interest bearing
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets								
Cash and money at call	21,265	-	-	-	-	-	21,265	45
Placements with banks and other financial institutions	113,349	887	89	-	-	-	114,325	18
Financial assets designated at fair value through profit or loss	81,139	86,321	80,269	317,875	175,752	142,801	884,157	369,285
Available-for-sale securities	2,051	1,105	100	-	-	-	3,256	1,275
Held-to-maturity securities	552	734	717	2,609	995	-	5,607	-
Loan portfolio	24,889	4,047	5,493	29	2	-	34,460	-
Interest-bearing assets	243,245	93,094	86,668	320,513	176,749	142,801	1,063,070	
Liabilities								
Placements by other HKSAR government funds with interest payable at market-based rates ¹	328	-	-	-	-	-	328	-
Exchange Fund Bills and Notes issued	17,526	36,890	34,862	41,104	10,702	683	141,767	-
Other debt securities issued	1,928	3,858	10,481	13,069	2,470	1,485	33,291	-
Mortgage-backed securities issued	1,663	-	654	1,912	-	-	4,229	-
Interest-bearing liabilities	21,445	40,748	45,997	56,085	13,172	2,168	179,615	
Interest rate derivatives (net position, notional amounts)	(24,399)	(12,216)	12,046	18,878	4,310	1,381	-	
Interest rate sensitivity gap	197,401	40,130	52,717	283,306	167,887	142,014	883,455	

¹ Placements by other HKSAR government funds with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (see note 24). Such placements are repayable on demand. As at 31 December 2007, such placements amounted to HK\$464,257 million (2006: Nil) and interest is payable at a fixed rate of 9.4 per cent per annum for 2008. The fixed rate is determined every January and will be revised in January 2009.

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Group-2006 Repricing period						Interest bearing total	Non- interest bearing
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets								
Cash and money at call	19,559	-	-	-	-	-	19,559	167
Placements with banks and other financial institutions	43,560	895	197	-	-	-	44,652	18
Financial assets designated at fair value through profit or loss	65,080	64,679	141,555	288,600	206,551	42,336	808,801	279,391
Available-for-sale securities	2,476	456	140	763	237	-	4,072	1,035
Held-to-maturity securities	250	391	652	2,297	1,163	-	4,753	-
Loan portfolio	28,219	4,050	69	36	2	-	32,376	-
Interest-bearing assets	159,144	70,471	142,613	291,696	207,953	42,336	914,213	
Less:								
Placements by other HKSAR government funds with interest payable at rates determined by reference to the investment income of the Fund ²	(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	123,952	52,274	103,261	211,466	150,533	30,567	672,053	

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Group-2006						Interest bearing total	Non-interest bearing
	Repricing period							
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Liabilities								
Trading liabilities	1,724	372	-	-	-	-	2,096	-
Placements by banks and other financial institutions	7,572	-	-	-	-	-	7,572	-
Placements by other HKSAR government funds with interest payable at market-based rates	2,408	2,118	-	-	-	-	4,526	-
Exchange Fund Bills and Notes issued	14,855	35,568	30,941	36,731	11,044	-	129,139	-
Other debt securities issued	2,799	5,789	4,938	13,025	1,344	1,015	28,910	-
Mortgage-backed securities issued	2,127	-	676	2,538	-	-	5,341	-
Interest-bearing liabilities	31,485	43,847	36,555	52,294	12,388	1,015	177,584	
Interest rate derivatives (net position, notional amounts)	(34,893)	3,174	9,194	17,411	4,150	964	-	
Interest rate sensitivity gap	57,574	11,601	75,900	176,583	142,295	30,516	494,469	

² Under the previous income-sharing arrangement, placements by other HKSAR government funds at rates determined by reference to the investment income of the Fund had the same interest rate risk profile as the Fund. Amounts placed by such funds were therefore allocated across the repricing periods in the same proportion as the total assets of the Fund.

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Fund-2007							Non-interest bearing
	Repricing period							
	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	21,195	-	-	-	-	-	21,195	27
Placements with banks and other financial institutions	110,915	780	-	-	-	-	111,695	-
Financial assets designated at fair value through profit or loss	81,139	86,321	80,269	317,875	175,752	142,801	884,157	369,285
Interest-bearing assets	213,249	87,101	80,269	317,875	175,752	142,801	1,017,047	
Liabilities								
Placements by other HKSAR government funds with interest payable at market-based rates ¹	328	-	-	-	-	-	328	-
Exchange Fund Bills and Notes issued	17,526	36,890	34,862	41,104	10,702	683	141,767	-
Interest-bearing liabilities	17,854	36,890	34,862	41,104	10,702	683	142,095	
Interest rate derivatives (net position, notional amounts)	(900)	(6,339)	900	4,339	2,000	-	-	
Interest rate sensitivity gap	194,495	43,872	46,307	281,110	167,050	142,118	874,952	

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Fund-2006 Repricing period						Interest bearing total	Non- interest bearing
	Up to 1 month	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years		
Assets								
Cash and money at call	19,525	-	-	-	-	-	19,525	136
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	808,801	279,391
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 ²	(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	1,724	372	-	-	-	-	2,096	-
Placements by banks and other financial institutions	7,572	-	-	-	-	-	7,572	-
Placements by other HKSAR government funds with interest payable at market-based rates	2,408	2,118	-	-	-	-	4,526	-
Exchange Fund Bills and Notes issued	14,855	35,568	30,941	36,731	11,044	-	129,139	-
Interest-bearing liabilities	26,559	38,058	30,941	36,731	11,044	-	143,333	
Interest rate derivatives (net position, notional amounts)	(2,900)	(4,000)	1,500	2,400	3,000	-	-	
Interest rate sensitivity gap	61,942	5,202	72,762	174,039	141,087	30,567	485,599	

Exchange Fund - Notes to the Financial Statements (cont.)

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

(b) Currency risk

The tables below summarise the currency exposure of the Group.

	Group			
	2007		2006	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	256.5	660.1	166.8	534.3
Other US dollar bloc currencies ¹	1,038.6	179.7	917.0	173.6
	1,295.1	839.8	1,083.8	707.9
Non-US dollar bloc	166.3	0.7	135.7	0.5
TOTAL	1,461.4	840.5	1,219.5	708.4

	Fund			
	2007		2006	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
US dollar bloc				
Hong Kong dollar	215.5	617.9	130.9	495.1
Other US dollar bloc currencies ¹	1,032.6	178.9	909.8	173.1
	1,248.1	796.8	1,040.7	668.2
Non-US dollar bloc	166.3	0.6	135.7	0.5
TOTAL	1,414.4	797.4	1,176.4	668.7

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

(c) Equity price risk

At 31 December 2007 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.

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.4.4 Sensitivity analysis

The VaR positions of the Fund at 31 December and during the year, based on a 95% confidence level and one-month time horizon, were as follows:

	Fund	
	2007	2006
VaR		
At 31 December	40,136	14,511
During the year		
Average	25,670	15,919
Maximum	44,450	21,574
Minimum	15,224	11,803

36.5 Liquidity risk

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

36.5.1 Management of liquidity risk

To ensure sufficient liquidity to meet liabilities and the ability to raise funds to meet exceptional needs, the Group invests primarily in liquid financial markets and instruments that are readily saleable to meet liquidity needs. There are internal investment restrictions to prevent undue concentrations in individual debt securities issues, debt securities issuers, and groups of closely related debt securities issuers. Such restrictions are derived based on various factors such as the nature or maturity of the securities. There are also limitations on the maximum proportion of assets that can be placed in fixed term deposits, and requirements regarding the ability to convert foreign currency assets into cash. All these restrictions and limits are designed to promote the liquidity of assets and consequently minimise the liquidity risk. Compliance with these limits is monitored by RMC and any breaches are reported to ISC and EFAC and are promptly followed up.

Exchange Fund - Notes to the Financial Statements (cont.)

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

36.5.2 Exposure to liquidity risk

The following tables show the remaining contractual maturities at the balance sheet date of major financial liabilities and commitments, which are based on contractual undiscounted cash flows and the earliest date on which the Group can be required to pay.

	Group-2007						Total
	Remaining maturity						
	Up to 1 month or on demand	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	
Certificates of Indebtedness	163,381	-	-	-	-	-	163,381
Government-issued currency notes and coins in circulation	7,545	-	-	-	-	-	7,545
Balance of the banking system	10,639	-	-	-	-	-	10,639
Placements by other HKSAR government funds	464,585	-	-	-	-	-	464,585
Exchange Fund Bills and Notes issued	17,586	37,488	36,931	44,767	11,212	739	148,723
Other debt securities issued	169	1,637	10,623	20,336	3,063	1,580	37,408
Mortgage-backed securities issued	12	48	828	3,538	269	-	4,695
Other liabilities	12,998	292	-	-	-	-	13,290
Loan commitments and other credit related commitments	89,024	-	-	-	-	-	89,024
TOTAL	765,939	39,465	48,382	68,641	14,544	2,319	939,290

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Group-2006						Total
	Remaining maturity						
	Up to 1 month or on demand	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	
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	1,725	374	-	-	-	-	2,099
Placements by banks and other financial institutions	7,572	-	-	-	-	-	7,572
Placements by other							
HKSAR government funds	322,415	31,075	-	-	-	-	353,490
Exchange Fund Bills and							
Notes issued	14,948	36,170	33,084	40,981	11,696	-	136,879
Other debt securities issued	1,071	4,782	7,063	16,331	2,887	-	32,134
Mortgage-backed							
securities issued	20	70	952	4,222	861	-	6,125
Other liabilities	14,090	256	-	-	-	-	14,346
Loan commitments and other credit related commitments	88,697	-	-	-	-	-	88,697
TOTAL	616,341	72,727	41,099	61,534	15,444	-	807,145

	Fund-2007						Total
	Remaining maturity						
	Up to 1 month or on demand	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	
Certificates of Indebtedness	163,381	-	-	-	-	-	163,381
Government-issued currency							
notes and coins in circulation	7,545	-	-	-	-	-	7,545
Balance of the banking system	10,639	-	-	-	-	-	10,639
Placements by other							
HKSAR government funds	464,585	-	-	-	-	-	464,585
Exchange Fund Bills and							
Notes issued	17,586	37,488	36,931	44,767	11,212	739	148,723
Other liabilities	8,158	275	-	-	-	-	8,433
Loan commitments and other credit related commitments	99,024	-	-	-	-	-	99,024
TOTAL	770,918	37,763	36,931	44,767	11,212	739	902,330

Exchange Fund - Notes to the Financial Statements (cont.)

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

	Fund - 2006						Total
	Remaining maturity						
	Up to 1 month or on demand	1-3 months	3 months to 1 year	1-5 years	5-10 years	Over 10 years	
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	1,725	374	-	-	-	-	2,099
Placements by banks and other financial institutions	7,572	-	-	-	-	-	7,572
Placements by other							
HKSAR government funds	322,415	31,075	-	-	-	-	353,490
Exchange Fund Bills and							
Notes issued	14,948	36,170	33,084	40,981	11,696	-	136,879
Other liabilities	9,231	246	-	-	-	-	9,477
Loan commitments and other credit related commitments	98,697	-	-	-	-	-	98,697
TOTAL	620,391	67,865	33,084	40,981	11,696	-	774,017

36.6 Mortgage insurance risk

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

Under the Mortgage Insurance Programme, the Group, through the HKMC, offers mortgage insurance that covers approved sellers for credit losses of up to 25% of the value of properties financed under mortgage loans where the loan amount exceeds 70% of the property value at origination. The Group reinsures the exposure with approved reinsurers. At 31 December 2007, the total risk-in-force was HK\$8.68 billion (2006: HK\$8.14 billion), of which HK\$3.51 billion (2006: HK\$2.92 billion) was retained by the Group after reinsurance.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal risk that the Group faces under its insurance contracts is that the actual claims exceed the carrying amount of the insurance liabilities. This could occur because the frequency or severity of claims 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.

Exchange Fund - Notes to the Financial Statements (cont.)

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

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

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

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

36.7 Operational risk

Operational risk is the risk of direct and indirect loss arising from a wide variety of causes associated with the Group's processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements. Operational risks arise from all of the Group's operations and are faced by all business segments.

The Group's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Group's reputation with overall cost effectiveness and to avoid control procedures that restrict initiative.

The primary responsibility for the development and implementation of controls to address operational risk rests with an internal high-level Risk Committee 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 operational risk.

The HKMA's operational risk management is supported by a formal risk assessment process. This is conducted on an annual basis and requires each division to assess and rank the potential impact and likelihood of occurrence of financial and operational risks. It also requires the relevant divisions to review the procedures and measures in place to address the identified risks. The assessment and ranking is 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 reports its findings to EFAC Audit Sub-Committee and the Chief Executive of the HKMA. It also follows up on outstanding issues to ensure that they are resolved in a proper manner.

Exchange Fund - Notes to the Financial Statements (cont.)

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

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.

There is no financial instrument whose fair value is estimated using a valuation technique that is not based on available observable market data.

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:

	Notes	Group			
		Carrying value		Fair value	
		2007	2006	2007	2006
Financial assets					
Held-to-maturity securities	11	5,607	4,753	5,644	4,714
Financial liabilities					
Other debt securities issued, not designated at fair value through profit or loss	26	28,320	25,929	28,324	25,949
Mortgage-backed securities issued, not designated at fair value through profit or loss	27	4,229	5,341	4,218	5,335

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 2007 and 2006.

38 COMPARATIVE FIGURES

As a result of adopting HKFRS 7, certain comparative figures have been adjusted or reclassified to conform with changes in disclosures in the current year and to show separately comparative amounts in respect of items disclosed for the first time in 2007. Further details are disclosed in note 3.

Exchange Fund - Notes to the Financial Statements (cont.)

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

39 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2007

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 2007 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
HKAS 1 (Revised), <i>Presentation of Financial Statements</i>	1 January 2009
HKFRS 8, <i>Operating Segments</i>	1 January 2009

40 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 26 March 2008.

Calendar of Events 2007

9 January

The International Monetary Fund releases its Staff Report giving support to the Government's economic and financial policy framework and reiterating its support for Hong Kong's commitment to the Linked Exchange Rate system.

12 March

The HKMA announces the issue for trial of a ten-dollar polymer note.

1 April

The new fee arrangement for calculating the investment income of the fiscal reserves placed with the Exchange Fund takes effect.

8 May

The HKMA outlines a strategy for Hong Kong to make a greater contribution to the reform and liberalisation of the Mainland's financial systems and, in the process, help to maintain Hong Kong's status as an international financial centre.

11 May

The China Banking Regulatory Commission announces the expansion of the investment scope for offshore wealth management services provided by commercial banks on the Mainland to include equity investments.

30 May

The HKMA issues a non-statutory guideline on the application of the Banking (Disclosure) Rules, completing the introduction of the new disclosure regime for authorized institutions under the Rules.

9 July

The new ten-dollar polymer note is put into circulation.

12 July

The first issue of renminbi bonds in Hong Kong is launched.

12 July

The Treasury Markets Association launches a daily price fixing for renminbi bonds issued in Hong Kong.

18 July

The HKMA announces an additional policy requirement relating to the continuing authorization of banks as note-issuing banks.

20 August

The State Administration of Foreign Exchange announces a pilot scheme for Mainland individuals to invest directly in securities in Hong Kong.

28 August

The HKMA launches the inaugural issue of 15-year Exchange Fund Notes.

7 September

The Government increases its shareholding in Hong Kong Exchanges and Clearing Limited to 5.88%.

25 September

Hong Kong continues to rank sixth in the global foreign exchange market according to the triennial survey conducted by the Bank for International Settlements.

23 October

The HKMA sells HK\$775 million against US dollars within the Convertibility Zone under the Currency Board arrangements.

29 October

A delivery-versus-payment link between Hong Kong's US dollar and Malaysia's ringgit real-time gross settlement systems is established.

19 November

The HKMA and the Financial Reporting Council enter into a Memorandum of Understanding to formalise the mechanisms for communication and information exchange and to strengthen the co-operation and mutual assistance between them.

20 November

An International Monetary Fund staff mission to Hong Kong welcomes the Government's policies to improve Hong Kong's competitiveness, and maintains its long-standing support for Hong Kong's commitment to the Linked Exchange Rate system.

23 November

The Hong Kong Association of Banks, the DTC Association and the HKMA jointly announce the expansion of the Commercial Credit Reference Agency to cover sole proprietorships and partnerships.

6 December

The HKMA announces the appointment of Mr David Carse as consultant to review the HKMA's work in the area of maintaining banking stability.

11 December

The HKMA launches the electronic trading platform for Exchange Fund Bills and Notes.

13 December

The HKMA and the Treasury Markets Association jointly organise the Treasury Markets Summit in Beijing.

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Annex: Authorized Institutions and Local Representative Offices at 31.12.2007

LICENSED BANKS*Incorporated in Hong Kong*

Bank of China (Hong Kong) Limited
 Bank of East Asia, Limited (The)
 China Construction Bank (Asia)
 Corporation Limited
 Chiyu Banking Corporation Limited
 Chong Hing Bank Limited
 CITIBANK (HONG KONG) LIMITED
 CITIC Ka Wah Bank Limited
 Dah Sing Bank Limited
 DBS BANK (HONG KONG) LIMITED

FUBON BANK (HONG KONG)
 LIMITED
 Hang Seng Bank, Limited
 Hongkong & Shanghai Banking
 Corporation Limited (The)
 Industrial and Commercial Bank of
 China (Asia) Limited
 MEVAS Bank Limited
 Nanyang Commercial Bank, Limited
 PUBLIC BANK (HONG KONG)
 LIMITED

Shanghai Commercial Bank Limited
 Standard Bank Asia Limited
 Standard Chartered Bank
 (Hong Kong) Limited
 Tai Sang Bank Limited
 Tai Yau Bank, Limited
 WING HANG BANK, LIMITED
 Wing Lung Bank Limited

Deletion in 2007

CHINA CONSTRUCTION BANK (ASIA)
 LIMITED

Incorporated outside Hong Kong

ABN AMRO Bank N.V.
 Agricultural Bank of China
 AIG Privat Bank AG
 also known as:
 AIG Private Bank Ltd
 Banque Privée AIG SA
 Banca Privata AIG SA
 Allahabad Bank
 American Express Bank Limited
 Australia and New Zealand Banking
 Group Limited
 Axis Bank Limited (formerly known as
 UTI Bank Limited)
 BANCA DI ROMA, SOCIETA' PER
 AZIONI
 Banca Monte dei Paschi di Siena
 S.p.A.
 Banco Bilbao Vizcaya Argentaria S.A.
 BANCO DE ORO – EPCI, INC.
 (Licence transfer from
 EQUITABLE PCI BANK, INC.)
 BANCO SANTANDER, S.A.#
 Bangkok Bank Public Company
 Limited

Bank of America, National
 Association
 Bank of Baroda
 Bank of China Limited
 Bank of Communications Co., Ltd.
 Bank of India
 Bank of Montreal
 Bank of New York (The)
 Bank of Nova Scotia (The)
 Bank of Scotland plc (formerly known
 as Governor and Company of the
 Bank of Scotland (The))
 BANK OF TAIWAN
 Bank of Tokyo-Mitsubishi UFJ, Ltd.
 (The)
 BANK SINOPAC
 Barclays Bank PLC
 Bayerische Hypo- und Vereinsbank
 Aktiengesellschaft
 Bayerische Landesbank
 BNP PARIBAS
 BNP PARIBAS PRIVATE BANK

CALYON
 Canadian Imperial Bank of
 Commerce
 CANARA BANK
 CATHAY BANK#
 CATHAY UNITED BANK COMPANY,
 LIMITED
 Chang Hwa Commercial Bank Ltd.
 Chiba Bank, Ltd. (The)
 China Construction Bank Corporation
 China Merchants Bank Co., Ltd.
 Chinatrust Commercial Bank, Ltd.
 Chugoku Bank, Ltd. (The)
 Citibank, N.A.
 Commerzbank AG
 Commonwealth Bank of Australia
 Coöperatieve Centrale Raiffeisen-
 Boerenleenbank B.A.
 Coutts Bank von Ernst AG
 also known as:
 Coutts Bank von Ernst SA
 Coutts Bank von Ernst Ltd

Addition in 2007

Annex: Authorized Institutions and Local Representative Offices at 31.12.2007 (cont.)

Credit Suisse also known as: Crédit Suisse Credito Svizzero Schweizerische Kreditanstalt	Industrial and Commercial Bank of China Limited	Shinkin Central Bank
DBS BANK LTD.	ING Bank N.V.	Shizuoka Bank, Ltd. (The)
DEPFA BANK plc [#]	INTESA SANPAOLO SPA (formerly known as Banca Intesa S.p.A. also known as: Intesa S.p.A.)	Societe Generale
Deutsche Bank Aktiengesellschaft	Iyo Bank, Ltd. (The)	SOCIETE GENERALE BANK & TRUST
DZ BANK AG Deutsche Zentral- Genossenschaftsbank, Frankfurt am Main	JPMorgan Chase Bank, National Association	Standard Chartered Bank
E.Sun Commercial Bank, Ltd.	KBC Bank N.V.	State Bank of India
EAST WEST BANK	Korea Exchange Bank	State Street Bank and Trust Company
EFG Bank	Land Bank of Taiwan Co., Ltd.	Sumitomo Mitsui Banking Corporation
Erste Bank der oesterreichischen Sparkassen AG	Malayan Banking Berhad	Svenska Handelsbanken AB (publ)
FAR EASTERN INTERNATIONAL BANK	MEGA INTERNATIONAL COMMERCIAL BANK CO., LTD.	TAIPEI FUBON COMMERCIAL BANK CO., LTD.
FIMAT INTERNATIONAL BANQUE SA	MELLI BANK PLC	TAISHIN INTERNATIONAL BANK CO., LTD
First Commercial Bank, Ltd.	Mitsubishi UFJ Trust and Banking Corporation	Taiwan Business Bank
Fortis Bank	Mizuho Corporate Bank, Ltd.	Taiwan Cooperative Bank, Ltd. [#]
Hachijuni Bank, Ltd. (The)	NATIXIS	Toronto-Dominion Bank
HANA BANK	National Australia Bank, Limited	UBS AG also known as: UBS SA UBS Ltd
HONG LEONG BANK BERHAD	National Bank of Pakistan	UCO Bank
HSBC BANK INTERNATIONAL LIMITED	Oversea-Chinese Banking Corporation Limited	UniCredito Italiano Societa' per Azioni
HSBC Bank plc	Philippine National Bank	Union Bank of India [#]
HSBC Bank USA, National Association	PT. Bank Negara Indonesia (Persero) Tbk.	UNITED COMMERCIAL BANK
HSBC Private Bank (Suisse) SA	Public Bank Berhad	United Overseas Bank Ltd.
HSH Nordbank AG	Punjab National Bank [#]	Wells Fargo Bank, National Association
Hua Nan Commercial Bank, Ltd.	Royal Bank of Canada	WestLB AG
ICICI BANK LIMITED	Royal Bank of Scotland public limited company (The)	Westpac Banking Corporation
Indian Overseas Bank	Shanghai Commercial & Savings Bank, Ltd. (The) [#]	Woori Bank
	Shiga Bank, Ltd. (The)	
		Deletion in 2007
		Banca Nazionale del Lavoro S.p.A. SANPAOLO IMI S.p.A.

[#] Addition in 2007

Annex: Authorized Institutions and Local Representative Offices at 31.12.2007 (cont.)

RESTRICTED LICENCE BANKS*Incorporated in Hong Kong*

AIG Finance (Hong Kong) Limited
 ALLIED BANKING CORPORATION
 (HONG KONG) LIMITED
 Banc of America Securities Asia
 Limited
 BOCI Capital Limited
 Citicorp International Limited
 GE Capital (Hong Kong) Limited
 Indover bank (Asia) Limited

Industrial and Commercial
 International Capital Limited
 J.P. MORGAN SECURITIES (ASIA
 PACIFIC) LIMITED
 KDB Asia Limited
 KOOKMIN BANK HONG KONG
 LIMITED
 Mitsubishi UFJ Securities (HK)
 Capital, Limited

ORIX Asia Limited
 SCOTIABANK (HONG KONG) LIMITED
 Societe Generale Asia Limited
 UBAF (Hong Kong) Limited

Deletion in 2007

Bank of Baroda (Hong Kong) Limited
 Shinhan Finance Limited

Incorporated outside Hong Kong

Bank of Ayudhya Public Company
 Limited
 CIMB BANK BERHAD
 Credit Agricole (Suisse) SA
 Industrial Bank of Korea
 Lloyds TSB Bank Plc

Mashreq Bank – Public Shareholding
 Company
 also known as:
 Mashreqbank psc
 PT. BANK MANDIRI (PERSERO) Tbk
 RBC Dexia Investor Services Bank
 S.A.
 Shinhan Bank

Siam Commercial Bank Public
 Company Limited (The)
 Thanakharn Kasikorn Thai
 Chamkat (Mahachon)
 also known as:
 KASIKORNBANK PUBLIC
 COMPANY LIMITED
 TMB Bank Public Company Limited
 Wachovia Bank, National Association

Annex: Authorized Institutions and Local Representative Offices at 31.12.2007 (cont.)

DEPOSIT-TAKING COMPANIES*Incorporated in Hong Kong*

AGRO ENTERPRISES COMPANY LIMITED	Hachijuni Asia Limited	Sumitomo Trust Finance (H.K.) Limited (The)
BCOM Finance (Hong Kong) Limited	HBZ Finance Limited	Vietnam Finance Company Limited
BPI International Finance Limited	Henderson International Finance Limited	Wing Hang Finance Company Limited
Chau's Brothers Finance Company Limited	HKCB Finance Limited	Wing Lung Finance Limited
Chong Hing Finance Limited	Hung Kai Finance Company Limited	WOORI GLOBAL MARKETS ASIA LIMITED
Commonwealth Finance Corporation Limited	Inchroy Credit Corporation Limited	
Corporate Finance (D.T.C.) Limited	KEXIM ASIA LIMITED	Deletion in 2007
Delta Asia Credit Limited	OCTOPUS CARDS LIMITED	BII Finance Company Limited
First Metro International Investment Company Limited	Orient First Capital Limited	Edward Wong Credit Limited
FUBON CREDIT (HONG KONG) LIMITED	PrimeCredit Limited	Indo Hong Kong International Finance Limited
Gunma Finance (Hong Kong) Limited	PUBLIC FINANCE LIMITED	Michinoku Finance (Hong Kong) Limited
Habib Finance International Limited	SHINHAN ASIA LIMITED	

Incorporated outside Hong Kong

NIL

LOCAL REPRESENTATIVE OFFICES

ANTWERPSE DIAMANTBANK NV also known as: ANTWERP DIAMOND BANK NV	Banca Popolare di Bergamo S.p.A.	Banco Popolare- Societa' Cooperativa#
Arab Bank plc	Banca Popolare di Novara – Societa' per Azioni	Banco Popular Español, S.A.
Banca del Gottardo	Banca Popolare di Sondrio Soc. Coop. a r.l.	Bank Hapoalim (Switzerland) Ltd
BANCA POPOLARE COMMERCIO E INDUSTRIA SPA	BANCA POPOLARE DI VICENZA – Societa' cooperativa per azioni (formerly known as Banca Popolare di Vicenza Soc. Coop. a r.l.)	Bank Julius Baer & Co. Ltd.
Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l.	Banco de Crédito e Inversiones	Bank Leumi Le-Israel B.M.
Banca Popolare di Ancona Societa' per azioni	Banco do Brasil S.A.	Bank of Fukuoka, Ltd. (The)
		Bank of Kyoto, Ltd. (The)
		BANK OF SCOTLAND INTERNATIONAL LIMITED#

Addition in 2007

Annex: Authorized Institutions and Local Representative Offices at 31.12.2007 (cont.)

Bank of Yokohama, Ltd. (The)	Japan Bank for International Cooperation	Shenzhen Development Bank Co., Ltd.
Banque Piguet & Cie SA	Juroku Bank, Ltd. (The)	Shoko Chukin Bank (The)
Banque Privee Edmond de Rothschild S.A.	Korea Development Bank (The)	Standard Bank of South Africa Ltd. (The)
BARCLAYS BANK (SUISSE) S.A.	Kredietbank S.A. Luxembourgeoise	STANDARD CHARTERED (JERSEY) LIMITED
BSI Ltd.	Landsbanki Íslands hf#	Union Bank of Taiwan
CARIPRATO – Cassa di Risparmio di Prato S.p.A.	LGT Bank in Liechtenstein AG also known as:	Unione di Banche Italiane Società Cooperativa per Azioni (formerly known as Banche Popolari Unite Società Cooperativa per azioni)
China Development Bank	LGT Bank in Liechtenstein Ltd.	Veneto Banca S.c.a.r.l.
China Everbright Bank Co., Ltd	LGT Banque de Liechtenstein S.A.	Verwaltungs- und Privat-Bank Aktiengesellschaft
CHINA MINSHENG BANKING CORPORATION LIMITED	LGT Banca di Liechtenstein S.A.	Yamaguchi Bank, Ltd. (The)
CITIC Group	LLOYDS TSB OFFSHORE LIMITED	Yamanashi Chuo Bank, Ltd.
CLEARSTREAM BANKING S.A.	Merrill Lynch Bank (Suisse) S.A.	Yuanta Commercial Bank Co., Ltd (formerly known as Fuhwa Commercial Bank Co., Ltd.)
Credit Industriel et Commercial	Metropolitan Bank and Trust Company	
Credito Bergamasco S.p.A.	Nanto Bank, Ltd. (The)	Deletion in 2007
D.A.H. Hambros Bank (Channel Islands) Limited	National Bank of Canada	Banco Popolare di Verona e Novara S.c.r.l.
DePfa Investment Bank Limited	Nishi-Nippon Bank, Ltd. (The)	Banco Santander, S.A. (formerly known as Banco Santander Central Hispano, S.A.)
DVB Bank N.V.	Norinchukin Bank (The)	Cathay Bank
eBANK Corporation	Ogaki Kyoritsu Bank, Ltd. (The)	Chinese Bank (The)
Euroclear Bank	Oita Bank, Ltd. (The)	Clariden Bank
Eurohypo Aktiengesellschaft#	P.T. Bank Central Asia	HSBC Bank Australia Limited
Fiduciary Trust Company International	P.T. Bank Rakyat Indonesia (Persero)	HSH Nordbank Private Banking S.A.
GUANGDONG DEVELOPMENT BANK CO., LTD.	Raiffeisen Zentralbank Osterreich AG	Kagoshima Bank, Ltd. (The)
Habib Bank A.G. Zurich	Resona Bank, Limited	Taiwan Cooperative Bank
HSBC Bank Canada	Rothschild Bank AG	
HSBC Guyerzeller Bank AG	Schroder & Co Bank AG also known as:	
HSBC Trinkaus & Burkhardt (International) S.A.	Schroder & Co Banque SA	
Investec Bank Limited	Schroder & Co Banca SA	
	Schroder & Co Bank Ltd	
	Schroder & Co Banco SA	
	Shanghai Pudong Development Bank Co., Ltd.	

Addition in 2007

Table A: Major Economic Indicators

	2003	2004	2005	2006	2007
I. Gross Domestic Product					
Real GDP growth (%)	3.0	8.5	7.1	7.0	6.3^[a]
Nominal GDP growth (%)	-3.3	4.6	7.0	6.7	9.3^[a]
Real growth of major expenditure components of GDP (%)					
– Private consumption expenditure	-1.3	7.0	3.0	6.0	7.8^[a]
– Government consumption expenditure	1.8	0.7	-3.2	0.1	2.3^[a]
– Gross domestic fixed capital formation	0.9	2.5	4.1	7.0	6.0^[a]
of which					
– Building and construction	-5.4	-10.7	-7.6	-7.3	0.2^[a]
– Machinery, equipment and computer software	7.0	10.3	12.8	19.1	6.6^[a]
– Exports	12.8	15.4	10.6	9.4	7.9^[a]
– Imports	11.4	13.8	8.0	9.1	8.9^[a]
GDP at current market prices (US\$ billion)	158.6	165.9	177.8	190.0	206.7^[a]
Per capita GDP at current market prices (US\$)	23,558	24,454	26,094	27,707	29,846^[a]
II. External Trade (HK\$ billion)					
Merchandise trade ^(b)					
– Domestic exports of goods	122.1	126.4	136.3	138.8	117.2^[a]
– Re-exports of goods	1,627.0	1,900.6	2,115.4	2,328.6	2,581.7^[a]
– Total imports of goods	1,794.1	2,099.5	2,311.1	2,576.3	2,852.5^[a]
– Merchandise trade balance	-45.0	-72.5	-59.3	-109.0	-153.7^[a]
Services trade					
– Exports of services	362.4	429.6	495.4	565.1	645.3^[a]
– Imports of services	203.4	242.5	264.2	287.9	320.1^[a]
– Services trade balance	159.0	187.1	231.2	277.2	325.2^[a]
III. Fiscal Expenditure and Revenue (HK\$ million, fiscal year)					
Total government expenditure	247,466	242,235	233,071	229,425	237,292^[a]
Total government revenue	207,338	263,591	247,035	288,014	352,967^[a]
Consolidated surplus/deficit	-40,128	21,356	13,964	58,589	115,675^[a]
Reserve balance as at end of fiscal year ^(c)	275,343	295,981	310,663	369,252	484,927^[a]
IV. Prices (annual change, %)					
Consumer Price Index (A)	-2.1	0.0	1.1	1.7	1.3
Composite Consumer Price Index	-2.6	-0.4	1.0	2.0	2.0
Trade Unit Value Indices					
– Domestic exports	0.2	1.5	2.2	-2.1	0.8
– Re-exports	-1.5	1.1	1.2	1.1	2.4
– Imports	-0.4	2.9	2.7	2.1	2.3
Property Price Indices					
– Residential flats	-11.9	26.6	17.9	0.8	11.6^[a]
– Office premises	-8.6	58.9	33.9	4.7	18.0^[a]
– Retail premises	0.6	39.5	25.1	2.8	12.2^[a]
– Flatted factory premises	-4.1	23.6	41.1	26.8	25.5^[a]

	2003	2004	2005	2006	2007
V. Labour					
Labour force (annual change, %)	0.0	1.3	0.6	1.2	1.7
Employment (annual change, %)	-0.7	2.5	2.0	2.1	2.5
Unemployment rate (annual average, %)	7.9	6.8	5.6	4.8	4.0
Underemployment rate (annual average, %)	3.5	3.2	2.7	2.4	2.2
Employment ('000) of which	3,197	3,277	3,341	3,410	3,495
– Manufacturing	268	231	224	217	204
– Financing, insurance, real estate and business services	472	482	506	529	548
– Wholesale, retail and import/export trades, restaurants and hotels	985	1,064	1,094	1,108	1,147
VI. Money Supply (HK\$ billion)					
HK\$ money supply					
– M1	354.8	412.6	348.2	387.9	454.4
– M2 ^(d)	2,107.3	2,208.6	2,329.7	2,777.8	3,281.3
– M3 ^(d)	2,122.9	2,219.6	2,345.8	2,795.7	3,300.8
Total money supply					
– M1	413.4	484.5	434.7	491.7	616.7
– M2	3,813.4	4,166.7	4,379.1	5,054.5	6,106.7
– M3	3,858.0	4,189.5	4,407.2	5,089.9	6,140.1
VII. Interest Rates (end of period, %)					
Three-month interbank rate	0.07	0.28	4.16	3.84	3.31
Savings deposit	0.01	0.01	2.32	2.26	1.26
One-month time deposit	0.01	0.02	2.68	2.52	1.61
Banks' 'Best lending rate'	5.00	5.00	7.75	7.75	6.75
Banks' 'Composite rate'	0.24	0.30	2.88	2.86	2.29
VIII. Exchange Rates (end of period)					
HK\$/US\$	7.763	7.774	7.753	7.775	7.802
Trade-weighted Effective Exchange Rate Index (Jan 2000=100)	98.8	96.0	98.4	94.3	88.6
IX. Foreign Currency Reserve Assets (US\$ billion) ^(e)	118.4	123.6	124.3	133.2	152.7
X. Stock Market (end of period figures)					
Hang Seng Index	12,576	14,230	14,876	19,965	27,813
Average price/earning ratio	19.0	18.7	15.6	17.4	22.5
Market capitalisation (HK\$ billion)	5,477.7	6,629.2	8,113.3	13,248.8	20,536.5

(a) The estimates are preliminary.

(b) Includes non-monetary gold.

(c) Includes changes in provision for loss in investments with the Exchange Fund.

(d) Adjusted to include foreign currency swap deposits.

(e) Excludes unsettled forward transactions but includes gold.

Annex and Tables

Table B: Performance Ratios of the Banking Sector ^(a)

	2003	2004	All AIs 2005	2006	2007
Asset Quality ^(b)	%	%	%	%	%
As % of total credit exposures ^(c)					
Total outstanding provisions/ impairment allowances	1.14	0.78	0.49	0.38	0.33
Classified ^(d) exposures:					
Gross	2.25	1.22	0.81	0.59	0.49
Net of specific provisions/ individual impairment allowances	1.54	0.81	0.54	0.41	0.34
Net of all provisions/impairment allowances	1.10	0.44	0.33	0.21	0.16
As % of total loans					
Total outstanding provisions/ impairment allowances	1.98	1.42	0.87	0.71	0.59
Classified ^(d) loans:					
Gross	3.74	2.11	1.34	1.05	0.76
Net of specific provisions/ individual impairment allowances	2.54	1.40	0.87	0.73	0.53
Net of all provisions/impairment allowances	1.76	0.70	0.47	0.34	0.17
Overdue > 3 months and rescheduled loans	2.81	1.54	0.94	0.76	0.50
Profitability					
Return on assets (operating profit)	0.93	1.06	1.07	1.13	1.41
Return on assets (post-tax profit)	0.81	0.97	0.97	1.01	1.24
Net interest margin	1.41	1.18	1.18	1.29	1.31
Cost-income ratio	45.8	48.7	50.4	50.8	46.6
Bad debt charge to total assets	0.24	0.01	0.01	0.03	0.04
Liquidity					
Loan to deposit ratio (all currencies)	57.1	55.8	56.8	51.9	50.5
Loan to deposit ^(e) ratio (Hong Kong dollar)	81.5	82.6	84.3	74.7	71.0

Asset quality

Delinquency ratio of residential mortgage loans

Credit card receivables

Delinquency ratio

Charge-off ratio

Profitability

Operating profit to shareholders' funds

Post-tax profit to shareholders' funds

Capital adequacyEquity to assets ratio ^(b)Capital adequacy ratio (consolidated) ^(f)

(a) Figures are related to HK office(s) only except where otherwise stated.

(b) Figures are related to HK office(s). For the locally incorporated AIs, figures include their overseas branches.

(c) Credit exposures include loans & advances, acceptances & bills of exchange held, investment debt securities issued by others, accrued interest, and commitments and contingent liabilities to or on behalf of non-banks.

(d) Denotes loans or exposures graded as "substandard", "doubtful" or "loss" in the HKMA's Loan Classification System.

(e) Includes swap deposits.

(f) From 1 January 2007, all locally incorporated AIs started to report their capital adequacy positions according to the Banking (Capital) Rules (i.e. the Basel II framework).

Retail banks				
2003	2004	2005	2006	2007
%	%	%	%	%
1.13	0.77	0.42	0.33	0.30
2.32	1.27	0.82	0.63	0.55
1.67	0.91	0.60	0.48	0.42
1.18	0.50	0.39	0.30	0.25
2.05	1.45	0.78	0.63	0.55
3.94	2.25	1.37	1.11	0.86
2.78	1.59	0.98	0.85	0.66
1.89	0.80	0.59	0.48	0.31
2.87	1.48	0.92	0.80	0.57
1.36	1.52	1.55	1.53	1.72
1.18	1.39	1.40	1.36	1.53
1.91	1.66	1.68	1.80	1.87
38.6	41.4	41.8	42.8	40.4
0.29	-0.02	-0.01	0.01	0.04
49.5	50.0	53.2	47.9	45.5
71.6	73.2	78.8	69.1	65.1
Surveyed Institutions				
2003	2004	2005	2006	2007
%	%	%	%	%
0.86	0.38	0.19	0.20	0.11
0.92	0.44	0.37	0.37	0.35
10.02	4.73	2.81	2.91	2.90
Locally incorporated banks				
2003	2004	2005	2006	2007
%	%	%	%	%
16.9	18.7	18.4	18.9	24.7
14.6	17.2	16.7	16.7	22.0
10.5	10.6	8.1	8.2	8.3
All locally incorporated AIs				
2003	2004	2005	2006	2007
%	%	%	%	%
15.3	15.4	14.8	14.9	13.4

Table C: Authorized Institutions: Domicile and Parentage

	2003	2004	2005	2006	2007
Licensed Banks					
(i) Incorporated in Hong Kong	23	24	24	24	23
(ii) Incorporated outside Hong Kong	111	109	109	114	119
Total	134	133	133	138	142
Restricted Licence Banks					
(i) Subsidiaries of licensed banks :					
(a) incorporated in Hong Kong	1	1	0	0	0
(b) incorporated outside Hong Kong	11	10	8	8	8
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	24	23	21	20	18
(iii) Bank related	3	3	1	0	0
(iv) Others	3	3	3	3	3
Total	42	40	33	31	29
Deposit-taking Companies					
(i) Subsidiaries of licensed banks :					
(a) incorporated in Hong Kong	9	7	6	5	5
(b) incorporated outside Hong Kong	3	2	2	3	3
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	15	14	13	13	10
(iii) Bank related	2	2	3	3	3
(iv) Others	10	10	9	9	8
Total	39	35	33	33	29
All Authorized Institutions	215	208	199	202	200
Local Representative Offices	87	85	86	84	79

Table D: Authorized Institutions: Region/Economy of Beneficial Ownership

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	03	04	05	06	07	03	04	05	06	07	03	04	05	06	07
Asia & Pacific															
Hong Kong	13	12	12	11	11	1	1	1	-	-	13	12	11	10	10
Australia	4	4	4	4	4	-	-	-	-	-	-	-	-	-	-
Mainland China	12	13	12	13	12	2	2	2	2	2	3	2	2	2	2
India	4	4	5	9	11	1	1	1	1	-	2	2	2	2	1
Indonesia	1	1	1	1	1	2	2	2	2	2	2	1	1	1	-
Japan	13	12	12	11	11	4	4	3	2	2	5	4	4	4	3
Malaysia	2	3	3	4	4	1	1	1	1	1	1	1	1	1	1
Pakistan	1	1	1	1	1	-	-	-	-	-	2	2	2	2	2
Philippines	2	2	2	2	2	1	1	1	1	1	3	3	3	3	3
Singapore	4	4	4	4	4	-	-	-	-	-	-	-	-	-	-
South Korea	3	3	3	3	3	5	4	4	5	4	1	2	2	3	3
Taiwan	13	14	15	15	17	-	-	-	-	-	-	1	1	1	1
Thailand	1	1	1	1	1	4	4	4	4	4	-	-	-	-	-
Vietnam	-	-	-	-	-	-	-	-	-	-	1	1	1	1	1
Sub-Total	73	74	75	79	82	21	20	19	18	16	33	31	30	30	27
Europe															
Austria	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Belgium	3	2	2	2	2	-	-	-	-	-	-	-	-	-	-
Denmark	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
France	6	6	5	7	7	2	2	2	3	3	-	-	-	-	-
Germany	9	8	8	7	8	-	1	1	-	-	-	-	-	-	-
Italy	6	6	6	6	4	-	-	-	-	-	-	-	-	-	-
Netherlands	3	3	3	3	3	-	-	-	-	-	-	-	-	-	-
Spain	1	1	1	1	2	-	-	-	-	-	-	-	-	-	-
Sweden	1	1	1	1	1	-	-	-	-	-	-	-	-	-	-
Switzerland	3	3	3	3	3	1	1	-	-	-	-	-	-	-	-
United Kingdom	9	10	10	10	10	2	1	1	1	1	-	-	-	-	-
Sub-Total	42	41	40	41	41	5	5	4	4	4	-	-	-	-	-
Middle East															
Bahrain	1	-	-	-	-	-	-	-	-	-	1	-	-	-	-
Iran	1	1	2	1	1	-	-	-	-	-	-	-	-	-	-
U.A.E.	-	-	-	-	-	1	1	1	1	1	1	-	-	-	-
Sub-Total	2	1	2	1	1	1	1	1	1	1	2	-	-	-	-
North America															
Canada	5	5	5	5	5	2	2	1	1	1	-	-	-	-	-
United States	11	11	10	11	12	9	8	6	6	6	3	3	2	2	1
Sub-Total	16	16	15	16	17	11	10	7	7	7	3	3	2	2	1
South Africa	1	1	1	1	1	2	2	1	-	-	-	-	-	-	-
Bermuda	-	-	-	-	-	1	1	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	1	1	1	1	1	1	1	1	1	1
Grand Total	134	133	133	138	142	42	40	33	31	29	39	35	33	33	29

Table E: Presence of World's Largest 500 Banks in Hong Kong

Positions at 31.12.2007	Number of Overseas Banks ^(b)					Licensed Banks ^(c)				
	03	04	05	06	07	03	04	05	06	07
World Ranking ^(a)										
1-20	20	20	19	20	20	30	33	28	33	33
21-50	23	22	25	23	22	21	19	25	23	22
51-100	32	28	27	26	26	27	23	23	21	19
101-200	44	42	39	37	38	22	22	19	20	25
201-500	51	45	47	50	46	18	17	22	25	23
Sub-total	170	157	157	156	152	118	114	117	122	122
Others	44	52	51	55	59	16	19	16	16	20
Total	214	209	208	211	211	134	133	133	138	142

(a) Top 500 banks/banking groups in the world ranked by total assets less contra items. Figures are extracted from The Banker, July 2007 issue.

(b) The sum of the number of licensed banks, restricted licence banks, deposit-taking companies and local representative offices is greater than the number of overseas banks with a presence in Hong Kong because of the multiple presence of some overseas banks.

(c) Consist of branches and subsidiaries of overseas banks.

Restricted Licence Banks ^(c)					Deposit-Taking Companies ^(c)					Local Representative Offices				
03	04	05	06	07	03	04	05	06	07	03	04	05	06	07
11	10	5	5	7	3	1	1	1	–	7	7	8	8	6
4	5	5	5	5	–	–	–	–	–	4	4	5	5	5
4	4	4	4	2	2	2	3	5	5	6	5	5	7	9
3	3	2	1	1	5	4	3	3	3	23	22	21	19	15
10	7	5	5	6	7	5	3	3	1	22	20	21	22	19
32	29	21	20	21	17	12	10	12	9	62	58	60	61	54
10	11	12	11	8	22	23	23	21	20	25	27	26	23	25
42	40	33	31	29	39	35	33	33	29	87	85	86	84	79

Table F: Balance Sheet: All Authorized Institutions and Retail Banks

All Authorized Institutions

(HK\$ bn)

	2003		
	HK\$	F/CY	Total
Assets			
Loans to customers	1,573	462	2,035
Inside Hong Kong ^(a)	1,542	267	1,809
Outside Hong Kong ^(b)	31	195	226
Interbank lending	438	2,175	2,614
Inside Hong Kong	295	177	472
Outside Hong Kong	144	1,998	2,142
Negotiable certificates of deposit (NCD)	86	58	144
Negotiable debt instruments, other than NCD	397	800	1,197
Other assets	289	212	501
Total assets	2,783	3,708	6,491
Liabilities			
Deposits from customers ^(c)	1,931	1,636	3,567
Interbank borrowing	428	1,489	1,918
Inside Hong Kong	285	185	470
Outside Hong Kong	143	1,305	1,448
Negotiable certificates of deposit	132	110	242
Other liabilities	495	268	764
Total liabilities	2,987	3,504	6,491

Retail Banks

(HK\$ bn)

	2003		
	HK\$	F/CY	Total
Assets			
Loans to customers	1,278	172	1,450
Inside Hong Kong ^(a)	1,266	146	1,412
Outside Hong Kong ^(b)	12	26	39
Interbank lending	330	836	1,166
Inside Hong Kong	247	110	358
Outside Hong Kong	83	726	809
Negotiable certificates of deposit (NCD)	58	38	96
Negotiable debt instruments, other than NCD	278	565	843
Other assets	233	78	312
Total assets	2,178	1,689	3,867
Liabilities			
Deposits from customers ^(c)	1,786	1,141	2,927
Interbank borrowing	90	265	354
Inside Hong Kong	31	26	58
Outside Hong Kong	58	238	296
Negotiable certificates of deposit	82	80	162
Other liabilities	361	63	424
Total liabilities	2,319	1,548	3,867

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

2004			2005			2006			2007		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,667	489	2,156	1,797	515	2,312	1,917	550	2,468	2,185	777	2,962
1,631	291	1,923	1,749	323	2,072	1,832	294	2,126	2,059	401	2,460
36	198	233	48	192	240	86	256	342	126	376	502
447	2,577	3,024	433	2,457	2,890	647	2,802	3,449	793	3,697	4,490
291	185	476	227	182	410	304	198	502	342	273	615
156	2,392	2,548	206	2,275	2,481	343	2,604	2,947	451	3,424	3,875
74	48	121	66	32	97	60	43	103	66	28	93
459	870	1,328	437	934	1,371	536	1,081	1,617	499	1,212	1,711
296	212	508	314	263	577	347	323	670	527	569	1,096
2,943	4,195	7,138	3,047	4,200	7,247	3,507	4,799	8,306	4,070	6,282	10,352

2,018	1,848	3,866	2,132	1,936	4,068	2,568	2,189	4,757	3,075	2,794	5,869
439	1,711	2,150	412	1,555	1,967	518	1,739	2,257	601	2,357	2,957
296	203	499	231	184	416	309	203	511	349	277	626
143	1,508	1,651	180	1,371	1,551	210	1,536	1,746	251	2,080	2,331
124	132	256	131	132	263	129	110	240	122	49	172
609	256	865	624	325	949	678	374	1,052	856	498	1,354
3,191	3,947	7,138	3,299	3,948	7,247	3,894	4,412	8,306	4,654	5,698	10,352

2004			2005			2006			2007		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,371	200	1,571	1,510	215	1,725	1,577	218	1,794	1,742	279	2,021
1,354	159	1,513	1,483	160	1,643	1,528	148	1,676	1,675	190	1,865
17	41	58	27	56	83	48	70	118	67	89	156
302	1,022	1,324	266	982	1,247	425	1,023	1,449	471	1,346	1,817
235	117	352	175	101	276	245	103	348	269	155	424
67	905	972	91	881	972	180	920	1,100	201	1,191	1,393
55	28	83	50	20	71	44	16	59	47	13	60
317	583	900	316	640	955	422	755	1,177	378	799	1,178
244	99	343	241	121	362	279	165	444	390	327	717
2,289	1,932	4,220	2,383	1,978	4,361	2,747	2,177	4,924	3,027	2,765	5,792

1,874	1,270	3,144	1,916	1,326	3,242	2,283	1,466	3,749	2,674	1,763	4,437
89	295	384	102	264	366	116	228	344	134	297	431
38	30	68	58	38	95	51	35	86	65	44	110
51	265	316	45	226	271	65	193	258	69	253	322
80	99	179	85	97	182	76	83	159	67	37	104
434	79	513	462	109	571	537	136	673	645	175	820
2,477	1,743	4,220	2,565	1,796	4,361	3,011	1,913	4,924	3,520	2,272	5,792

Table G: Major Balance Sheet Items by Region/Economy of Beneficial Ownership of Authorized Institutions

(HK\$ bn)

		Mainland China	Japan	US	Europe	Others	Total
Total Assets	2006	1,383	590	728	2,110	3,494	8,306
	2007	1,632	603	909	3,041	4,167	10,352
Deposits from Customers	2006	1,017	159	345	778	2,458	4,757
	2007	1,191	179	465	1,107	2,928	5,869
Loans to Customers	2006	571	149	129	454	1,165	2,468
	2007	704	174	135	602	1,347	2,962
Loans to Customers Inside Hong Kong ^(a)	2006	488	112	116	335	1,075	2,126
	2007	578	133	121	414	1,214	2,460
Loans to Customers Outside Hong Kong ^(b)	2006	83	37	13	119	89	342
	2007	127	42	13	188	132	502

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

Figures may not add up to total due to rounding.

Table H: Flow of Funds for All Authorized Institutions and Retail Banks

All Authorized Institutions (HK\$ bn)	2006			2007		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Increase/(Decrease) in						
Assets						
Loans to customers	120	36	156	268	227	494
Inside Hong Kong ^(a)	83	(29)	54	227	107	334
Outside Hong Kong ^(b)	37	64	102	41	120	160
Interbank lending	213	345	558	147	894	1,041
Inside Hong Kong	76	16	92	39	75	113
Outside Hong Kong	137	330	467	108	820	928
All other assets	127	218	345	149	362	511
Total assets	460	599	1,059	564	1,483	2,046
Liabilities						
Deposits from customers ^(c)	437	253	690	507	605	1,112
Interbank borrowing	107	183	290	82	618	701
Inside Hong Kong	77	18	95	41	74	115
Outside Hong Kong	29	165	194	42	544	586
All other liabilities	52	28	79	171	63	234
Total liabilities	595	464	1,059	760	1,286	2,046
Net interbank borrowing/(lending)	(107)	(162)	(269)	(64)	(276)	(341)
Net customer lending/(borrowing)	(317)	(217)	(534)	(239)	(378)	(618)
Retail Banks (HK\$ bn)						
Increase/(Decrease) in						
Assets						
Loans to customers	66	3	69	165	61	227
Inside Hong Kong ^(a)	45	(12)	33	147	42	189
Outside Hong Kong ^(b)	21	15	36	19	19	37
Interbank lending	160	41	201	45	323	368
Inside Hong Kong	71	2	72	24	52	76
Outside Hong Kong	89	40	129	21	271	292
All other assets	138	155	293	70	204	273
Total assets	365	199	563	280	588	868
Liabilities						
Deposits from customers ^(c)	367	140	507	391	297	688
Interbank borrowing	13	(36)	(22)	19	69	88
Inside Hong Kong	(7)	(3)	(10)	14	10	24
Outside Hong Kong	20	(33)	(13)	4	60	64
All other liabilities	66	13	79	99	(8)	92
Total liabilities	446	117	563	509	359	868
Net interbank borrowing/(lending)	(146)	(77)	(224)	(26)	(254)	(280)
Net customer lending/(borrowing)	(301)	(137)	(438)	(226)	(236)	(462)

(a) Defined as loans for use in Hong Kong plus trade-financing loans.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

Table I: Loans to and Deposits from Customers by Category of Authorized Institutions

(HK\$ bn)

	Loans to Customers				Deposits from Customers ^(a)			
	HK\$	F/CY	Total	%	HK\$	F/CY	Total	%
2003								
Licensed banks	1,465	448	1,913	94	1,916	1,608	3,524	99
Restricted licence banks	85	12	97	5	12	27	38	1
Deposit-taking companies	24	1	25	1	3	2	5	-
Total	1,573	462	2,035	100	1,931	1,636	3,567	100
2004								
Licensed banks	1,581	475	2,057	95	2,007	1,839	3,846	99
Restricted licence banks	67	12	79	4	8	7	15	-
Deposit-taking companies	19	2	21	1	3	2	5	-
Total	1,667	489	2,156	100	2,018	1,848	3,866	100
2005								
Licensed banks	1,750	500	2,250	97	2,116	1,927	4,043	99
Restricted licence banks	26	13	39	2	12	7	19	-
Deposit-taking companies	22	1	23	1	3	2	5	-
Total	1,797	515	2,312	100	2,132	1,936	4,068	100
2006								
Licensed banks	1,870	532	2,402	97	2,552	2,174	4,725	99
Restricted licence banks	24	17	41	2	14	13	26	1
Deposit-taking companies	23	1	24	1	3	2	5	-
Total	1,917	550	2,468	100	2,568	2,189	4,757	100
2007								
Licensed banks	2,128	749	2,877	97	3,057	2,782	5,839	99
Restricted licence banks	32	26	59	2	15	9	25	-
Deposit-taking companies	25	2	27	1	3	2	5	-
Total	2,185	777	2,962	100	3,075	2,794	5,869	100

(a) Hong Kong dollar customer deposits include swap deposits.

A "-" sign denotes a figure of less than 0.5.

Figures may not add up to total due to rounding.

Table J: Loans to Customers Inside Hong Kong by Economic Sector

All Authorized institutions (HK\$ bn)	2003		2004		2005		2006		2007	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Sector										
Hong Kong's visible trade	100	6	130	7	142	7	152	7	183	7
Manufacturing	80	4	99	5	119	6	103	5	122	5
Transport & transport equipment	110	6	121	6	123	6	123	6	145	6
Building, construction & property development and investment	360	20	386	20	451	22	492	23	578	24
Wholesale and retail trade	94	5	99	5	101	5	105	5	117	5
Financial concerns (other than authorized institutions)	147	8	168	9	179	9	185	9	251	10
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	87	5	77	4	68	3	60	3	59	2
to purchase other residential property	529	29	534	28	539	26	535	25	564	23
other purposes	137	8	149	8	169	8	182	9	221	9
Others	164	9	158	8	183	9	188	9	220	9
Total ^(a)	1,809	100	1,923	100	2,072	100	2,126	100	2,460	100
Retail banks (HK\$ bn)										
Sector										
Hong Kong's visible trade	80	6	103	7	115	7	124	7	147	8
Manufacturing	53	4	65	4	75	5	68	4	79	4
Transport & transport equipment	68	5	76	5	81	5	82	5	88	5
Building, construction & property development and investment	301	21	331	22	378	23	397	24	460	25
Wholesale and retail trade	65	5	67	4	69	4	73	4	78	4
Financial concerns (other than authorized institutions)	65	5	65	4	70	4	76	5	88	5
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	57	4	51	3	68	4	60	4	59	3
to purchase other residential property	501	35	515	34	526	32	522	31	551	30
other purposes	104	7	126	8	140	9	152	9	178	10
Others	117	8	113	7	120	7	123	7	139	7
Total ^(a)	1,412	100	1,513	100	1,643	100	1,676	100	1,865	100

(a) Defined as loans for use in Hong Kong plus trade-financing loans.
Figures may not add up to total due to rounding.

Table K: Deposits from Customers

(HK\$ bn)	All Authorized Institutions				Retail banks			
	Demand	Savings	Time	Total	Demand	Savings	Time	Total
Hong Kong Dollar ^(a)								
2003	227	936	768	1,931	203	927	656	1,786
2004	272	1,033	713	2,018	250	1,023	601	1,874
2005	206	742	1,183	2,132	190	734	992	1,916
2006	238	933	1,397	2,568	219	924	1,140	2,283
2007	296	1,110	1,669	3,075	273	1,096	1,305	2,674
Foreign Currency								
2003	59	341	1,236	1,636	38	307	796	1,141
2004	72	399	1,378	1,848	47	357	866	1,270
2005	86	402	1,448	1,936	56	353	917	1,326
2006	104	426	1,659	2,189	70	373	1,024	1,466
2007	162	520	2,112	2,794	112	451	1,200	1,763
Total								
2003	286	1,278	2,004	3,567	241	1,234	1,452	2,927
2004	344	1,432	2,090	3,866	297	1,379	1,468	3,144
2005	292	1,144	2,631	4,068	246	1,087	1,909	3,242
2006	341	1,359	3,057	4,757	289	1,297	2,164	3,749
2007	459	1,629	3,781	5,869	385	1,547	2,506	4,437

(a) Hong Kong dollar customer deposits include swap deposits.
 Figures may not add up to total due to rounding.

Table L: Geographical Breakdown of Net External Claims/(Liabilities) of All Authorized Institutions

(HK\$ bn) Region/Economy	2006			2007		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Asia & Pacific	697	(199)	498	644	(301)	343
South Korea	189	21	210	316	32	348
Australia	275	37	312	301	40	341
Singapore	329	(79)	250	392	(100)	292
India	5	9	14	21	28	50
New Zealand	3	0	3	4	0	4
Maldives	1	0	1	2	0	2
Republic of Kazakhstan	1	0	1	1	0	1
Vietnam	(4)	0	(3)	(1)	2	1
Bangladesh	1	0	1	1	0	1
Sri Lanka	1	0	1	0	0	0
Cambodia	0	0	0	0	0	(1)
Malaysia	0	11	10	(7)	6	(1)
Vanuatu	0	(1)	(1)	0	(2)	(2)
Indonesia	(5)	(4)	(9)	(2)	(4)	(6)
Western Samoa	0	(6)	(6)	0	(8)	(8)
Brunei	(5)	(1)	(6)	(6)	(2)	(8)
Philippines	(18)	(11)	(29)	(26)	(16)	(41)
Thailand	(29)	1	(27)	(35)	(7)	(43)
Japan	(34)	65	31	(109)	62	(46)
Taiwan	59	(97)	(38)	65	(133)	(68)
Macau SAR	(65)	(16)	(82)	(69)	(10)	(79)
Mainland China	(5)	(125)	(130)	(203)	(186)	(389)
Others	(2)	(2)	(4)	(1)	(4)	(5)
North America	158	186	343	139	184	323
United States	127	188	315	109	191	300
Canada	31	(3)	28	31	(7)	24
Caribbean	(5)	9	4	6	(22)	(16)
Cayman Islands	12	16	28	41	(7)	33
Bermuda	0	1	1	0	4	4
Netherlands Antilles	1	(2)	(1)	0	4	4
Panama	0	0	0	0	(1)	(1)
Bahamas	(19)	(7)	(26)	(35)	(9)	(44)
Others	0	1	2	0	(12)	(12)
Africa	(8)	(5)	(13)	(12)	(4)	(15)
Liberia	0	(1)	(1)	0	(1)	(1)
South Africa	0	0	0	(3)	0	(3)
Mauritius	(8)	(2)	(10)	(9)	2	(7)
Others	0	(3)	(3)	0	(5)	(5)

Table L: Geographical Breakdown of Net External Claims/(Liabilities) of All Authorized Institutions (cont.)

(HK\$ bn) Region/Economy	2006			2007		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Latin America	0	(3)	(3)	4	(2)	1
Brazil	0	0	0	3	0	3
Chile	0	1	1	0	0	0
Peru	0	(1)	(1)	0	0	0
Venezuela	0	(1)	(1)	0	(1)	(1)
Others	0	(2)	(2)	0	(1)	(1)
Eastern Europe	2	0	1	4	1	5
Western Europe	1,208	16	1,223	1,794	40	1,834
United Kingdom	543	(17)	526	974	(34)	940
France	157	1	158	296	(11)	285
Switzerland	111	(4)	107	137	(3)	134
Netherlands	100	13	113	97	21	118
Germany	46	6	52	65	3	68
Republic of Ireland	26	(5)	21	31	22	53
Belgium	56	2	58	52	1	53
Sweden	31	6	36	37	2	39
Jersey	4	2	6	5	28	33
Denmark	18	0	18	30	0	30
Italy	31	1	33	20	4	24
Norway	20	2	21	19	0	19
Austria	16	0	16	14	0	14
Luxembourg	36	6	42	8	2	10
Finland	3	0	4	7	0	7
Iceland	4	0	4	4	0	5
Turkey	0	0	0	2	0	2
Malta	0	0	0	0	1	1
Greece	0	1	2	0	1	1
Portugal	2	0	2	1	0	1
Guernsey	(1)	2	2	(2)	2	(1)
Spain	4	(1)	3	(4)	0	(4)
Others	1	(1)	0	0	1	1
Middle East	9	11	20	11	18	29
United Arab Emirates	4	10	14	17	15	31
Qatar	0	0	1	1	2	3
Saudi Arabia	2	0	2	2	1	3
Kuwait	0	1	1	0	1	2
Israel	(2)	0	(3)	0	0	0
Egypt	0	0	0	(1)	0	0
Oman	(1)	0	(1)	0	0	0
Bahrain	7	(1)	6	(7)	0	(8)
Others	(1)	0	(1)	0	0	0
Others ^(a)	14	0	14	7	0	6
Overall Total	2,073	15	2,088	2,598	(87)	2,511

(a) "Others" include economies not listed above and positions in relation to international organisations. Figures may not add up to total due to rounding.

Abbreviations used in this Report

AI	-	Authorized institution	HKDPB	-	Hong Kong Deposit Protection Board
AIGV	-	Accord Implementation Group's Validation Sub-group	HKFRS	-	Hong Kong Financial Reporting Standards
AML	-	Anti-money-laundering	HKICL	-	Hong Kong Interbank Clearing Limited
APEC	-	Asia-Pacific Economic Co-operation	HKICPA	-	Hong Kong Institute of Certified Public Accountants
APG	-	Asia/Pacific Group on Money Laundering	HKMA	-	Hong Kong Monetary Authority
ASA	-	Alternative Standardised Approach	HKMC	-	Hong Kong Mortgage Corporation Limited
ASEAN	-	the Association of Southeast Asian Nations	HKSAR	-	Hong Kong Special Administrative Region
ATM	-	Automated teller machine	HSI	-	Hang Seng Index
CAAP	-	Capital adequacy assessment process	IFRS	-	International Financial Reporting Standards
CAMEL	-	Capital adequacy, Asset quality, Management, Earnings and Liquidity of banks	IMF	-	International Monetary Fund
CAR	-	Capital Adequacy Ratio	IPO	-	Initial public offering
CBRC	-	China Banking Regulatory Commission	IRB	-	Internal Ratings-based approach
CCASS	-	Central Clearing and Settlement System	approach	-	Internal Ratings-based approach
CCPI	-	Composite Consumer Price Index	ISC	-	Investment Sub-Committee
CCR	-	Counterparty credit risk	IT	-	Information technology
CCRA	-	Commercial credit reference agency	LIBOR	-	London Interbank Offered Rate
CEPA	-	Closer Economic Partnership Arrangement	MDB	-	Multilateral Development Bank
CFT	-	Counter-terrorist-financing	MFSC	-	Monetary and Financial Stability Committee
CHATS	-	Clearing House Automated Transfer System	MMD	-	Monetary Management Department
CI	-	Certificate of Indebtedness	MoU	-	Memorandum of Understanding
CLS	-	Continuous Linked Settlement	N.A.	-	Not applicable
CMU	-	Central Moneymarkets Unit	NAB	-	New Arrangements to Borrow
CRA	-	Credit rating agency	NCD	-	Negotiable certificate of deposit
CRCC	-	Credit Review and Compliance Committee	NDI	-	Negotiable debt instrument
CSSO	-	Clearing and Settlement Systems Ordinance	OCL	-	Octopus Cards Limited
CU	-	Convertibility Undertaking	OECD	-	Organisation for Economic Co-operation and Development
DCA	-	Debt collection agency	PES	-	Public Enquiry Service
DvP	-	Delivery-versus-Payment	PvP	-	Payment-versus-Payment
ECAI	-	External credit assessment institutions	QDII	-	Qualified Domestic Institutional Investors
EFAC	-	Exchange Fund Advisory Committee	ReI	-	Relevant individuals
EFBN	-	Exchange Fund Bills and Notes	RI	-	Registered Institutions
EMEAP	-	Executives' Meeting of East Asia-Pacific Central Banks	RMB	-	Renminbi
EPS	-	Easy Pay System	RMC	-	Risk Management and Compliance Division
FATF	-	Financial Action Task Force	RMD	-	Reserves Management Department
F/CY	-	Foreign currency	RTGS	-	Real Time Gross Settlement
FID	-	Financial Infrastructure Department	SAFE	-	State Administration of Foreign Exchange
GDP	-	Gross Domestic Product (in real terms unless otherwise stated)	SFC	-	Securities and Futures Commission
GSC	-	Governance Sub-Committee	SPM	-	Supervisory Policy Manual
HIBOR	-	Hong Kong Interbank Offered Rate	SRP	-	Supervisory review process
HKAS	-	Hong Kong Accounting Standards	STO	-	Standardised Approach
			TMA	-	Treasury Markets Association
			VaR	-	Value-at-Risk
			WGBS	-	Working Group on Banking Supervision

Reference Resources

The *HKMA Annual Report* is published in April or May each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include

HKMA Quarterly Bulletin (on-line publication)

(published in March, June, September and December each year)

HKMA Monthly Statistical Bulletin (on-line publication)

(published in two batches on the third and sixth business days of each month)

Guide to Hong Kong Monetary and Banking Terms (Third Edition)

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Money and Banking in Hong Kong: A Historical Timeline

Educational leaflets on various topics including notes and coins and banking issues

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The HKMA website contains detailed and extensive information on the whole range of the HKMA's work. This information includes press releases, statistics, speeches, guidelines and circulars, research reports, and features on topical issues.

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