

The Exchange Fund

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Report of the Director of Audit



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

Independent Audit Report

To the Financial Secretary

I certify that I have audited the financial statements of the Exchange Fund set out on pages 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 financial 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				Total	2006			
Up to 3 months		3-12 months	1-5 years	Over 5 years	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.)

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\$7.7725	US\$1=HK\$7.7974	US\$1=HK\$7.7725
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.]

	Currency Board Operations		Reserves Management		Group 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
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 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		
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.