



HONG KONG MONETARY AUTHORITY
香港金融管理局

ANNUAL REPORT 2008

Hong Kong Monetary Authority

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

The HKMA's policy objectives are

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

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

The HKMA's offices are at

55/F, Two International Finance Centre,
8 Finance Street,
Central,
Hong Kong
Telephone : (852) 2878 8196
Facsimile : (852) 2878 8197
E-mail : hkma@hkma.gov.hk


The HKMA Information Centre is located at 55/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong and is open from 10:00 a.m. to 6:00 p.m. Monday to Friday and 10:00 a.m. to 1:00 p.m. on Saturday (except public holidays). The Centre consists of an exhibition area and a library containing materials on Hong Kong's monetary, banking and financial affairs and central banking topics.

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

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The chapter on Banking Stability in this Annual Report is the report on the working of the Banking Ordinance and the activities of the office of the Monetary Authority during 2008 submitted by the Monetary Authority to the Financial Secretary in accordance with section 9 of the Banking Ordinance.

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

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

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

Highlights of 2008

Economic and Banking Environment

Economic activities slow in the second half of 2008 as Hong Kong and its trading partners are affected by the global financial crisis. Real GDP growth moderates to 2.5%.

The Hong Kong banking sector remains financially sound and well capitalised. Asset quality remains good but signs of deterioration increase towards the end of the year.

Monetary Stability

The Hong Kong dollar remains stable against the US dollar.

The HKMA introduces temporary measures to increase the supply of liquidity and reduce borrowing costs to relieve stress in the money market and help restore the normal functioning of the interbank market.

Banking Stability

The Review of the HKMA's Work on Banking Stability is published.

The failure of the US investment bank Lehman Brothers results in losses to investors around the world including in Hong Kong. The HKMA deploys resources to deal with complaints about the sale by banks of investment products related to Lehman Brothers.

A temporary 100% deposit guarantee and Contingent Bank Capital Facility are introduced to help support market confidence amid increasing tension in global credit markets.

Market Infrastructure

New measures are introduced to make the RTGS systems and Central Moneymarkets Unit more efficient.

Agreements are reached with Indonesia and Mainland China to establish cross-border RTGS links.

Memorandums of Understanding are agreed with Dubai and Malaysia on promoting Islamic finance.

International Financial Centre

The Mainland authorities agree to expand renminbi business in Hong Kong.

New measures under CEPA are introduced to assist Hong Kong banks in operating their businesses in China.

Hong Kong's credit rating is raised to AA+ by Standard & Poor's.

Reserves Management

The Exchange Fund sees an investment loss of 5.6% amid the global financial crisis.

Total assets of the Exchange Fund are \$1,560.3 billion at the end of 2008.

Chief Executive's Statement



During the past year the financial world has seen some of the most dramatic events in living memory. The US sub-prime crisis turned into a global financial crisis, leading to a sharp slowdown in the world economy. The worldwide credit crunch was so severe that financial intermediation all but ceased for a time. Some of the best-known financial institutions were forced to sell themselves to rivals, or were bailed out by their governments, or ceased to exist altogether. Central banks and governments around the world took unprecedented actions to boost liquidity in the financial markets and stimulate their economies. Although Asia was not at the centre of the crisis, the HKMA, like other central banks in the region, has had to act quickly to safeguard monetary and financial stability against waves of shock and contagion.

That Hong Kong has come through so far with its monetary system intact and its financial system still robust is due, in no small part, to the actions that we have taken, not just during the crisis itself but also over many years, to prepare for unforeseen events. The investment we as a society have made in the Linked Exchange Rate system, which passed its 25th year in 2008, and in a strong and stable banking sector have paid dividends and continue to do so. Sound preparation in robust systems and a strong fiscal position have certainly served

us well. But the outlook is an extremely complex one, and we must expect prolonged uncertainty and hardship. Continued vigilance, and a readiness to deal with the unexpected, will be necessary in facing the difficult times ahead.

A ROUGH PATCH FOR THE ECONOMY

After four years of above-trend growth, the rate of expansion in the local economy declined to 2.5% in 2008 compared with 6.4% in 2007. Much of that slowdown occurred in the second half as we felt the effects of the global financial crisis and domestic demand and export growth both declined. Inflation, which was becoming a concern earlier in the year slowed with the CCPI easing to 4.6% year on year in December from 6.3% in August as food prices on the Mainland stabilised and housing rents eased. The unemployment rate also rose in the fourth quarter, and into 2009, rising to 5.0% in February: we can expect it to continue to rise as recession among our major trading partners deepens. And of course the slowdown was reflected in asset prices as residential property prices declined by 11% during 2008 and the Hang Seng Index shed nearly half of its value.

DEALING WITH A FINANCIAL CRISIS

By September, when the US investment bank Lehman Brothers filed for bankruptcy protection, it was clear that the global financial system was in serious trouble. The trust between counterparties that is essential to the normal functioning of the system had largely evaporated and interbank rates had increased sharply, with one-month LIBOR rising from 2.65% to 3.95% during September and the equivalent HIBOR rising to 4.36% at the end of the month. This made it difficult for financial institutions to secure funding and led them to reduce lending. In Hong Kong, on 24 September a small-scale run on a bank, resulting from unfounded market rumours, led to further tightness in the local money market. At the same time, demand from banks for Exchange Fund paper for liquidity management increased.

In response, the HKMA injected liquidity into the banking system by buying US dollars for Hong Kong dollars within the Convertibility Zone in September and October and these operations, together with repeated triggering of the strong-side Convertibility Undertaking in the remainder of the year, helped to ease the tightness in the market. The HKMA introduced five temporary measures on 30 September to provide collateralised liquidity to banks that might need it, either through or outside of the Discount Window, to give banks greater assurance about the availability of funds and make them more willing to lend in the interbank market. These measures were then refined in early November in response to market needs. An additional \$12 billion of three-month Exchange Fund Bills, which can be used for borrowing at the Discount Window, were issued between late October and early December to assist banks in their liquidity management and improve their access to the new measures.

Chief Executive's Statement

In mid-October the Financial Secretary announced two precautionary measures to bolster public confidence in the banking system: using the Exchange Fund to provide a temporary 100% deposit guarantee and a contingent capital facility for banks. These measures, both of which are set to expire at the end of 2010, were designed to stabilise the banks' deposits as a source of funding and give them comfort that additional capital would be available in case they need it. Finally, the HKMA lowered the price of liquidity at the Discount Window by adjusting the formula for determining the Base Rate on 9 October.

All of these measures were designed to respond to developments in the market and, wherever possible, to pre-empt further problems by supporting confidence. As a result of them, the interbank market returned to largely normal functioning by the end of the year, although uncertainties remain in the global environment. The HKMA will remain vigilant and stand ready to take further measures if needed.

THE EXCHANGE FUND

Asset prices declined around the world in 2008 with global equities markets measured by the MSCI Global Index declining by 42%. The investment environment in Hong Kong and elsewhere affected the Exchange Fund, which experienced an investment loss of \$75 billion, or 5.6%, for the year, its first loss since the HKMA was established in 1993. Any loss is a matter of regret, but the conservative investment approach of the Fund helped to ensure that losses were kept to a relatively modest level. The Fund also had minimal or no exposure to financial institutions that experienced problems during the year or to the kinds of toxic investment assets that caused many of those problems. The compounded average annual investment return of the Exchange Fund since 1994 is 6.1%, well above the compounded annual inflation rate of 1.4% for the same period. The Exchange Fund is not primarily an investment fund: its statutory purposes are to maintain the exchange value of the Hong Kong dollar and to maintain the stability and integrity of the monetary and financial systems of Hong Kong. The Fund continues to serve those purposes effectively.

Another important point to note is that, under the fee arrangement with the Government for the use by the Exchange Fund of the fiscal reserves, the Treasury received \$46.4 billion. This helps to insulate the fiscal reserves from the immediate effects of the financial crisis and to make annual budgeting more predictable and stable.

HONG KONG DOLLAR STABILITY

The Hong Kong dollar remained stable in 2008 despite the volatility in financial markets. The exchange rate was stable in the first eight months of the year despite the strengthening of the renminbi, inflationary pressure in Hong Kong and volatility in financial markets. The market remained calm when the renminbi appreciated past the Hong Kong dollar Convertibility Zone in February, suggesting that we had been successful in managing market expectations.

The worsening of the financial crisis in September made currency markets extremely volatile. As a result of the unwinding of carry trades and repatriation of funds to Hong Kong, the Hong Kong dollar strengthened with the strong-side Convertibility Undertaking being triggered repeatedly in the last two months of the year. This created conditions that were conducive to an easing of monetary conditions, which was helpful in addressing the effects of the crisis.

THE BANKING SECTOR

The Hong Kong banking sector entered the crisis in 2008 in a stronger condition than many of its counterparts in other economies and this helped it to withstand the effects. The average consolidated capital adequacy ratio of the locally incorporated authorized institutions actually rose slightly from 13.4% in 2007 to 14.8% at the end of 2008, well above the statutory minimum and in marked contrast to the position of banking sectors overseas, where a number of governments had to inject capital into banks. Liquidity ratios were also well above statutory requirements. But local banks could not escape the effects of the crisis altogether and profitability deteriorated with both interest and non-interest income declining and cost-to-income ratios rising. Asset quality also showed some signs of deterioration, although the levels of problem loans remained low by historical standards with the classified loan ratio slightly above 1% at the end of 2008, and the quality of mortgage and credit card lending remaining stable. Total lending by retail banks increased by 10.6% while the loan-to-deposit ratio increased from 45.5% in 2007 to 47.2%. However, the last quarter of the year saw a contraction in lending by banks. This is something that will need to be watched carefully, with the aim of preventing credit tightness and economic downturn feeding off each other and producing a downward spiral. The HKMA has been encouraging banks to be particularly supportive of their SME customers, which are the backbone of the Hong Kong economy, and the banks have generally responded positively, for example by establishing their own SME lending funds and by taking part in the Government's newly introduced Special Loan Guarantee Scheme.

A key focus of our banking supervisory work during the year – and in fact since mid-2007 – was to step up our monitoring of Als' exposures to problem institutions and assets, and stress-testing their capital adequacy in light of the growing financial stress. This was in addition to our normal banking supervisory work and naturally attracted little attention. But it is essential, especially at times of stress, for us to maintain a close and careful watch over the health and soundness of individual institutions and the system as a whole.

Another issue that absorbed a great deal of time and resources, and attracted much more public attention, was the investigation of complaints about mis-selling by banks of structured investment products related to Lehman Brothers. After the US investment bank failed in mid-September, the HKMA began to receive large numbers of complaints from investors who had suffered losses on these products, well over 19,000 had been received by the end of the

Chief Executive's Statement

year. Other complaints brought the total for the year to over 21,000 compared with only 469 for 2007. More than 200 staff, both HKMA personnel and some seconded from external auditing firms, were deployed to handle the complaints. All of us will feel great sympathy for those who suffered investment losses because of the collapse of Lehman Brothers and I fully understand their desire and that of the wider community for an early resolution of their complaints. We are working to conclude our investigations as quickly as possible, consistent with the need to observe due process. There is still much work to be done in this area and additional resources have been earmarked for this in 2009.

Towards the end of the year, we agreed with the People's Bank of China (PBoC) an arrangement for Hong Kong banks operating on the Mainland to obtain renminbi liquidity from the PBoC by providing collateral to the HKMA in Hong Kong for safe keeping. This helps ease renminbi liquidity pressure on Hong Kong banks' Mainland branches and subsidiaries.

In late 2007 the HKMA appointed Mr David Carse, an independent consultant, to conduct a review of its work in maintaining banking stability. The review was completed in July 2008 and published for public consultation concluding at the end of October. The review made a number of recommendations and we will prepare a policy response, taking into account the submissions from the public and the industry, in 2009.

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE

The global financial situation called for an increase in our regional surveillance and co-operation to identify and address possible risks to stability in the region and Hong Kong. The HKMA has also been active in international discussions on the reform of the global financial system. At the end of the year, the State Council agreed to allow Mainland and Hong Kong enterprises, on a trial basis, to use renminbi to settle trade transactions in Hong Kong. A new measure under the fifth supplement to CEPA allows the data centres of Hong Kong banks' Mainland-incorporated institutions to be operated in Hong Kong, increasing economies of scale and reducing technology-related risk. Both these measures help to raise Hong Kong's status as an international financial centre and demonstrate the Mainland authorities' confidence in our financial system.

Standard and Poor's raised Hong Kong's sovereign credit ratings to AA+, the highest ever, and the other agencies confirmed our AA ratings. These ratings reflect a growing recognition of Hong Kong's sound economic fundamentals, fiscal sustainability and diversified economy.

A number of steps were taken during 2008 to provide a platform in Hong Kong for Islamic finance, which is becoming increasingly important in the global economy. These were part of a four-part strategy: to develop the necessary infrastructure, for example, by assisting the Government to review the tax and regulatory framework; to raise Hong Kong's profile by organising and

participating in events and entering into a memorandum of understanding with the Dubai International Financial Centre Authority; to encourage development of shariah-compliant financial products; and to raise market awareness locally and internationally.

FINANCIAL INFRASTRUCTURE

One of the prerequisites of an international financial centre and of stable financial markets is a financial infrastructure that is safe, reliable and efficient. This does not just happen on its own and the HKMA places great emphasis, in co-operation with official and private operators here and overseas, on ensuring that Hong Kong's systems are robust, up to date and connected with those of other jurisdictions. In 2008 the operating hours of the local RTGS systems and Central Moneymarkets Unit were extended to meet regional demand, and agreements were reached to establish links between Hong Kong's RTGS systems and those of Indonesia and the Mainland. The payment and settlement systems continued to operate efficiently and turnover increased in a number of areas.

GOVERNANCE AND TRANSPARENCY

As always the HKMA was aided in its work in 2008 by the wise counsel and advice of EFAC and its Sub-Committees, which were of particular value to us in this challenging year. We strive to maintain the highest standards of professionalism in our work and to be accountable to the community both generally and through the Legislative Council. As in earlier years, I briefed the Legislative Council's Panel on Financial Affairs three times during the year on the work of the HKMA and my senior colleagues and I attended a number of meetings to answer questions on aspects of our work and provided written submissions on a variety of subjects.

Finally, 2008 made particularly heavy demands on HKMA staff, many of whom found themselves working longer hours than normal – often much longer – under considerable pressure. As always, they rose to the challenge without fuss or complaint. I would like to extend my heartfelt thanks to all my colleagues.



Joseph Yam
Chief Executive

About the HKMA

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

THE HKMA'S LEGAL MANDATE

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

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

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

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

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

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

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

 The HKMA

THE HKMA AND THE HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT

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

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

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

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

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

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

About the HKMA

ACCOUNTABILITY AND TRANSPARENCY

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

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

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

a policy of transparency and accessibility. This policy has two main objectives:

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

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

 [Viewpoint](#)

 [HKMA Information Centre](#)

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

 > [Press Releases > Exchange Fund](#)

 > [Supervisory Policy Manual](#)

 > [Guidelines and Circulars](#)

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

 > [Legislative Council Issues](#)

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

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

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

About the HKMA

EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC. The Committee held seven meetings in 2008 to discuss the full range of issues relating to the work of the HKMA, most of which had been previously discussed by the relevant Sub-Committees.

The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues. The Sub-Committee met seven times in 2008 to consider a range of subjects including the HKMA's expenditure budget, the HKMA's performance assessment, the annual pay review, the *HKMA Annual Report*, and strategic planning matters. The Sub-Committee also received regular reports on the work of the HKMA.

The *Audit Sub-Committee* reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits. None of the members of the Sub-Committee performs any executive functions in the HKMA. The Sub-Committee met three times in 2008.

The *Currency Board Sub-Committee* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted to the Sub-Committee are published. In 2008 the Sub-Committee met four times.

 [Press Releases > Monetary Policy](#)

The *Investment Sub-Committee* monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. The Sub-Committee held four meetings during 2008.

The *Financial Infrastructure Sub-Committee* monitors the work of the HKMA in relation to the development and operation of the financial infrastructure in Hong Kong and makes recommendations on measures and initiatives relating to the HKMA's responsibilities for promoting the safety, efficiency and development of Hong Kong's financial infrastructure. In 2008 the Sub-Committee met once and received regular reports on development of financial infrastructure.

Banking Advisory Committee

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

Deposit-taking Companies Advisory Committee

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

Chief Executive's Committee

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

Brief biographies of EFAC Members and the Code of Conduct for EFAC Members may be found on the HKMA website.

A Register of Members' Interests, which contains the declarations of interests by Members, is available for public inspection from 9:00 a.m. to 5:00 p.m. Monday to Friday (except public holidays) at the HKMA offices.

 [The HKMA > Advisory Committees](#)

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

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE

Chairman



The Hon. John TSANG Chun-wah, JP
The Financial Secretary

Members



Mr Joseph YAM, GBS, JP
The Monetary Authority



Mr Henry FAN Hung-ling, SBS, JP
Managing Director
CITIC Pacific Limited



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



Mr Simon IP Sik-on, JP



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



Mr Thomas KWOK Ping-kwong, SBS, JP
Vice Chairman and Managing Director
Sun Hung Kai Properties Limited



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



Mr John CHAN Cho-chak, GBS, JP
Chairman
The Hong Kong Jockey Club
(from 1 November 2008)



Dr Patrick FUNG Yuk-bun
Chairman and Chief Executive
Wing Hang Bank Limited



Mr Benjamin HUNG Pi-cheng
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
(from 1 January 2009)



Professor the Hon. Lawrence J. LAU, JP
Vice-Chancellor
The Chinese University of Hong Kong



Dr the Hon. Marvin CHEUNG Kin-tung, DBA Hon., GBS, JP
(until 30 September 2008)



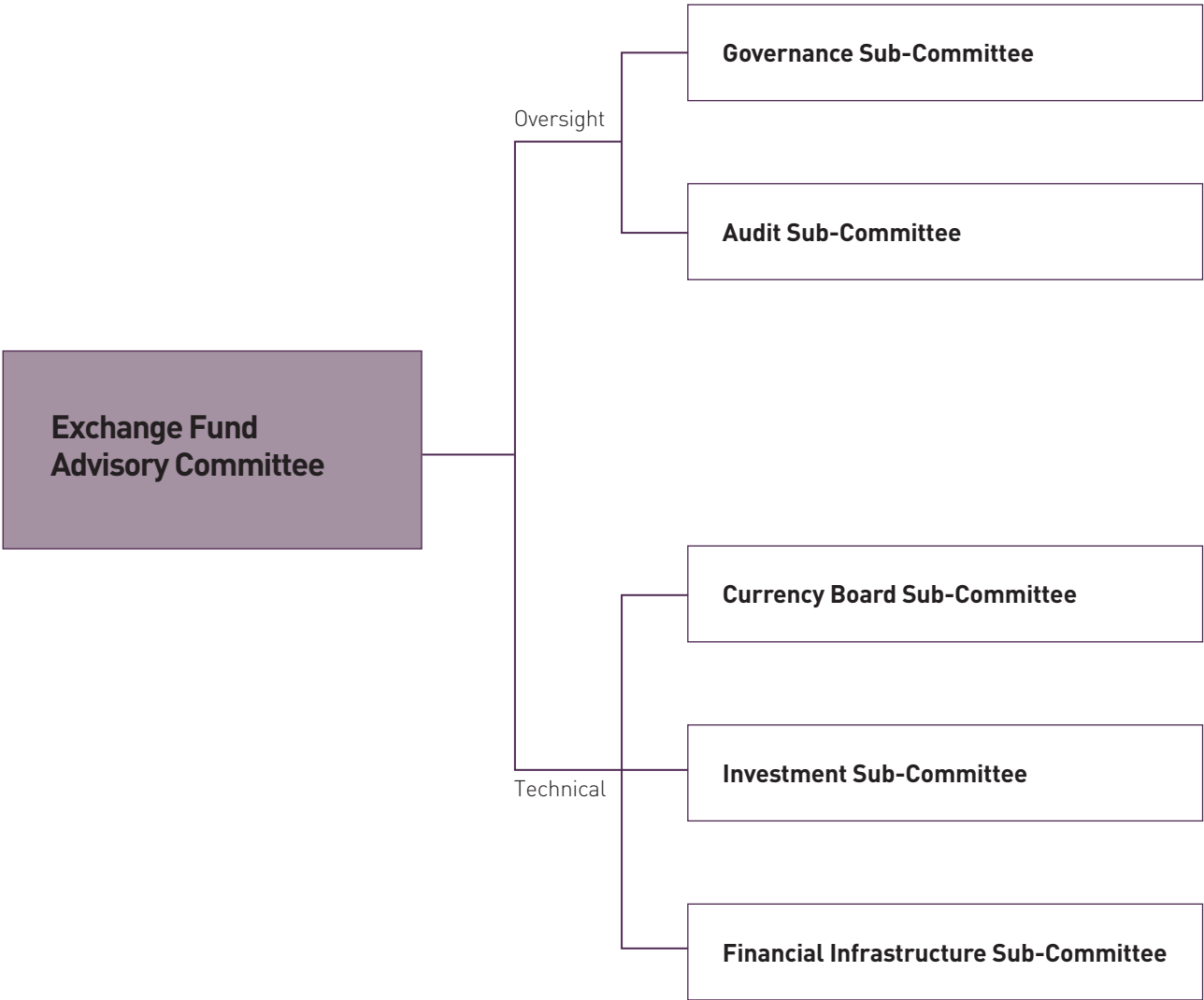
Mr David SUN Tak-kei, BBS, JP
Chairman and Managing Partner
Far East Area, Ernst & Young

Mr Nicholas SALLNOW-SMITH
Regional Chief Executive for North East Asia
Standard Chartered Bank (Hong Kong) Limited
(from 1 January 2008 until 31 December 2008)

Secretary
Mr Trevor KEEN

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

Members

Mr Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

Mr Simon IP Sik-on, JP

Mr Thomas KWOK Ping-kwong, SBS, JP

Vice Chairman and Managing Director

Sun Hung Kai Properties Limited

Professor the Hon. Lawrence J. LAU, JP

Vice-Chancellor

The Chinese University of Hong Kong

(from 1 May 2008)

Mr David SUN Tak-kei, BBS, JP

Chairman and Managing Partner

Far East Area

Ernst & Young

(from 1 May 2008)

Dr the Hon. Marvin CHEUNG Kin-tung, DBA Hon., GBS, JP

(until 30 September 2008)

Secretary

Mr Trevor KEEN

Terms of reference

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

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE AUDIT SUB-COMMITTEE

Chairman

Mr David SUN Tak-kei, BBS, JP

Chairman and Managing Partner

Far East Area

Ernst & Young

(from 1 October 2008)

Dr the Hon. Marvin CHEUNG Kin-tung, DBA Hon., GBS, JP

(until 30 September 2008)

Members

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Mr Simon IP Sik-on, JP

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Mr Benjamin HUNG Pi-cheng

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

(from 1 January 2009)

Mr Nicholas SALLNOW-SMITH

Regional Chief Executive for North East Asia

Standard Chartered Bank (Hong Kong) Limited

(from 1 January 2008 until 31 December 2008)

Secretary

Mr Trevor KEEN

Terms of reference

(1) The objectives of the Audit Sub-Committee are as follows:

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

(2) The functions of the Sub-Committee include, but are not restricted to, the following:

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

(3) Authority

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

(4) Meetings

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

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE CURRENCY BOARD SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Mr Peter PANG, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Y K CHOI, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Eddie YUE, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr John GREENWOOD

Group Chief Economist

INVESCO Asset Management Limited

Professor TSANG Shu-ki

Department of Economics

Hong Kong Baptist University

Professor the Hon. Lawrence J. LAU, JP

Vice-Chancellor

The Chinese University of Hong Kong

Mr HE Guangbei

Chairman

The Hong Kong Association of Banks

Secretary

Mr Trevor KEEN

Terms of reference

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

THE EXCHANGE FUND ADVISORY COMMITTEE INVESTMENT SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Mr Eddie YUE, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Mr Henry FAN Hung-ling, SBS, JP

Managing Director

CITIC Pacific Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Mr Benjamin HUNG Pi-cheng

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

(from 1 January 2009)

Mr Nicholas SALLNOW-SMITH

Regional Chief Executive for North East Asia

Standard Chartered Bank (Hong Kong) Limited

(from 1 January 2008 until 31 December 2008)

Secretary

Mr Trevor KEEN

Terms of reference

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

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE FINANCIAL INFRASTRUCTURE SUB-COMMITTEE

Chairman

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Mr Eddie YUE, JP

Deputy Chief Executive

Hong Kong Monetary Authority

Mr Christopher CHENG Wai-chee, GBS, JP

Chairman

USI Holdings Limited

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Mr Vincent CHENG Hoi-chuen, GBS, JP

Chairman

The Hongkong and Shanghai Banking Corporation Limited

Dr Patrick FUNG Yuk-bun

Chairman and Chief Executive

Wing Hang Bank Limited

Secretary

Mr Trevor KEEN

Terms of reference

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

THE BANKING ADVISORY COMMITTEE

Chairman

The Hon. John TSANG Chun-wah, JP

The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Professor the Hon. K C CHAN, SBS, JP

Secretary for Financial Services and the Treasury

Mr HE Guangbei

Vice Chairman and Chief Executive

Bank of China (Hong Kong) Limited

Representing Bank of China (Hong Kong) Limited

Mr Peter WONG Tung-shun, JP

Executive Director

The Hongkong and Shanghai Banking Corporation Limited

Representing The Hongkong and Shanghai Banking Corporation Limited

Mr Benjamin HUNG Pi-cheng

Executive Director and Chief Executive Officer

Standard Chartered Bank (Hong Kong) Limited

Representing Standard Chartered Bank (Hong Kong) Limited

(from 1 January 2008)

Mrs Mignonne CHENG

Head of North and East Asia

BNP Paribas

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

Chairman and Chief Executive

The Bank of East Asia Limited

Mr James C K WONG

Chief Executive Officer

Dah Sing Life Assurance Company Limited

Mr Stanley Y F WONG, JP

Director and Deputy General Manager

Industrial and Commercial Bank of China (Asia) Limited

Mr Eiichi YOSHIKAWA

Director

Regional Head for Hong Kong

General Manager

The Bank of Tokyo-Mitsubishi UFJ, Ltd.

Hong Kong Branch

(from 5 May 2008)

Mr Takaaki KATO

General Manager

Mizuho Corporate Bank, Ltd.

Hong Kong Branch

(until 31 March 2008)

Mr Sim S. LIM

Citi Country Officer, Hong Kong

Head of Markets & Banking, Hong Kong & Taiwan

Citibank, N.A.

(until 30 June 2008)

Mrs Doreen CHAN HUI Dor-lam

President and Chief Executive Officer

CITIC Ka Wah Bank Limited

(until 30 November 2008)

Ms Maria XUEREB

Financial Services Partner

Deloitte Touche Tohmatsu

(until 30 November 2008)

Secretary

Ms Theresa KWAN

Advisory Committees

THE DEPOSIT-TAKING COMPANIES ADVISORY COMMITTEE

Chairman

The Hon. John TSANG Chun-wah, JP

The Financial Secretary

Ex Officio Member

Mr Joseph YAM, GBS, JP

The Monetary Authority

Members

Professor the Hon. K C CHAN, SBS, JP

Secretary for Financial Services and the Treasury

Mr Martin WHEATLEY

Chief Executive Officer

Securities and Futures Commission

Representing the Securities and Futures Commission

Mr Geoffrey J MANSFIELD

Chairman

The DTC Association (The Hong Kong Association of Restricted Licence

Banks and Deposit-taking Companies)

Representing The DTC Association

Ms Connie LAU Yin-hing

Chief Executive

Consumer Council

Representing the Consumer Council

The Hon. CHAN Kam-lam, SBS, JP

Member

Legislative Council

Mr Michael CHANG Ming-yuen

Chairman

Fubon Credit (Hong Kong) Limited

Mr Frederick CHIN

Chief Executive

Banc of America Securities Asia Limited

Ms Kitty IU Pui-pui

Managing Director

Scotiabank (Hong Kong) Limited

Mr Mervyn JACOB

Partner

Assurance, Financial Services Practice

PricewaterhouseCoopers

Mr Frank J WANG

Executive Director and Deputy Chief Executive

Wing Hang Finance Company Limited

Mr Kazunori OKIMOTO

Chairman and Chief Executive Officer

Orix Asia Limited

(from 17 April 2008)

Mr CHOI Jong Ha

Managing Director and Chief Representative

KDB Asia Limited

(until 18 February 2008)

Mr Erik Helge WEINER

Chairman and Chief Executive

JP Morgan Securities (Asia Pacific) Limited

(until 7 April 2008)

Secretary

Ms Theresa KWAN

Chief Executive's Committee



CHIEF EXECUTIVE

Joseph YAM, GBS, JP

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



DEPUTY CHIEF EXECUTIVE

Peter PANG, JP

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



DEPUTY CHIEF EXECUTIVE

Y K CHOI, JP

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



DEPUTY CHIEF EXECUTIVE

Eddie YUE, JP

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

Chief Executive's Committee



GENERAL COUNSEL

Stefan GANNON, JP

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



EXECUTIVE DIRECTOR (BANKING DEVELOPMENT)

Raymond LI, JP

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



EXECUTIVE DIRECTOR (EXTERNAL)

Arthur YUEN, JP

Arthur Yuen is responsible for multilateral agencies and central bank co-operation, China research, financial market integration issues, as well as the HKMA's office in New York. He joined the HKMA in 1996 as Head of Administration and has since taken up different responsibilities including research and liaison on Mainland China economic and market development issues before being appointed Head of Banking Supervision in 2000. He took up the position as Executive Director (Banking Development) in July 2004 and Executive Director (Banking Supervision) in June 2005. He was appointed to the current position in July 2008.



EXECUTIVE DIRECTOR (RESEARCH)

Hans GENBERG

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



EXECUTIVE DIRECTOR (MONETARY MANAGEMENT)

Edmond LAU, JP

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



EXECUTIVE DIRECTOR (CORPORATE SERVICES)

Christopher MUNN, JP

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



EXECUTIVE DIRECTOR (RESERVES MANAGEMENT)

Francis CHU, JP

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



EXECUTIVE DIRECTOR (FINANCIAL INFRASTRUCTURE)

Esmond LEE

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

Chief Executive's Committee



EXECUTIVE DIRECTOR (BANKING POLICY)

Karen KEMP

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



EXECUTIVE DIRECTOR (BANKING SUPERVISION)

Nelson MAN

Nelson Man is responsible for banking supervision. He joined the HKMA in 1994 as a senior manager in the Banking Development Division and was involved in the deregulation of the interest rate rules and establishment of the consumer credit reference agency. He was promoted to Division Head in banking supervision in 2000 and was appointed to his present position in July 2008. Before joining the HKMA, Mr Man worked in the Hong Kong Securities and Futures Commission for four years.



CHIEF EXECUTIVE OFFICER (HONG KONG MORTGAGE CORPORATION)

James H LAU Jr, JP

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

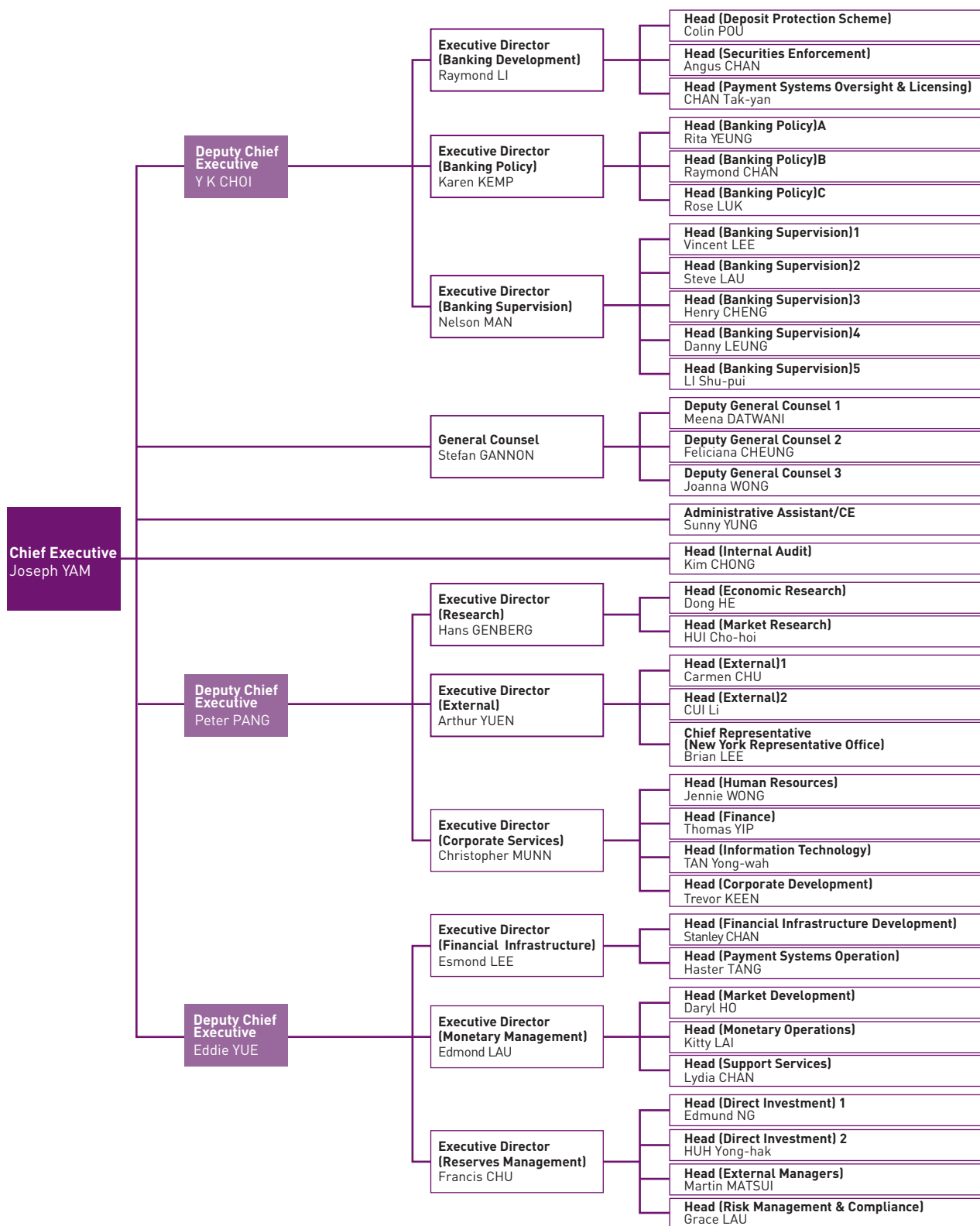
EXECUTIVE DIRECTOR (EXTERNAL)

Julia LEUNG, JP

Julia Leung left the HKMA in July 2008.

HKMA Organisation Chart

1 April 2009



Economic and Banking Environment

Economic activities slowed notably in the second half of 2008 as a result of the global financial crisis and the downturn among Hong Kong's major trading partners. Inflationary pressures receded following weaker domestic demand and smaller increases in food prices and rental costs. Unemployment rose towards the end of the year. With the effects of the global financial crisis on the real sector still unfolding, and the depth and length of recessions in major industrialised economies uncertain, there are significant risks to the economic outlook for 2009.

THE ECONOMY IN REVIEW

Overview

Following the robust economic expansion over the past few years, real GDP growth slowed markedly in the second half of 2008 as the domestic economy was hit by the global financial crisis. For 2008 as a whole, real GDP growth moderated to 2.5% from 6.4% in 2007, reflecting weaker domestic demand and a slowdown in export growth (Table 1). Labour market conditions deteriorated as business owners streamlined their operations under the worsening economic environment. The unemployment rate rose to a 16-month high of 4.1% in December from 3.2% in July. Inflationary pressures receded as lower food and commodity prices dragged down import-price inflation. The decline in property prices in the second half also helped alleviate rental-cost pressures.

Turbulence in global financial markets caused by the collapse of the sub-prime mortgage market in the US resulted in tightened credit conditions in Hong Kong. Interest rates for interbank borrowings rose in September and October before easing gradually towards the end of

2008. On a quarter-on-quarter basis, growth in domestic credit turned negative to -3.5% in the fourth quarter of 2008 from 2.7% in the third quarter, in part reflecting more conservative lending by banks. Meanwhile, growth in Hong Kong dollar broad money picked up to 2.9% from 2.6%. With domestic credit contracting and broad money expanding, the Hong Kong dollar loan-to-deposit ratio declined to 77.6% in December from a near three-year high of 83.8% in August 2008.

Weakening domestic demand

Domestic demand weakened in the second half of 2008, as the effects of the global financial crisis fed through to domestic real-sector activities. Growth in private consumption slowed to 1.8% in 2008 from 8.5% in 2007, as rising unemployment and falling asset prices weighed on household spending. Tightened credit conditions and the weakening external environment also restrained private investment. In particular, machinery and equipment spending contracted by 18.7% year on year in the fourth quarter, while construction spending declined by 3.6%. An expansion in the Government's operating expenditure and the implementation of various relief measures boosted

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

	2008					2007				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	4.5	2.2	0.0	-1.9	1.1	3.1	4.7	6.3	5.5	5.0
Government Consumption Expenditure	0.1	0.3	0.2	0.2	0.2	0.2	0.3	0.2	0.3	0.2
Gross Domestic Fixed Capital Formation	2.1	1.1	0.7	-3.7	-0.1	0.1	1.5	-0.2	1.7	0.8
Change in Inventories	-0.4	-0.2	0.7	-0.9	-0.2	0.8	1.2	0.6	1.5	1.0
Net Exports of Goods	-1.1	-1.5	-1.6	3.2	-0.1	-1.7	-3.7	-3.7	-5.3	-3.6
Net Exports of Services	2.1	2.4	1.8	0.4	1.6	3.1	2.2	3.6	3.1	3.0
GDP	7.3	4.3	1.7	-2.5	2.5	5.6	6.1	6.7	6.9	6.4

Figures may not add up to total due to rounding.

Source: Census and Statistics Department.

Economic and Banking Environment

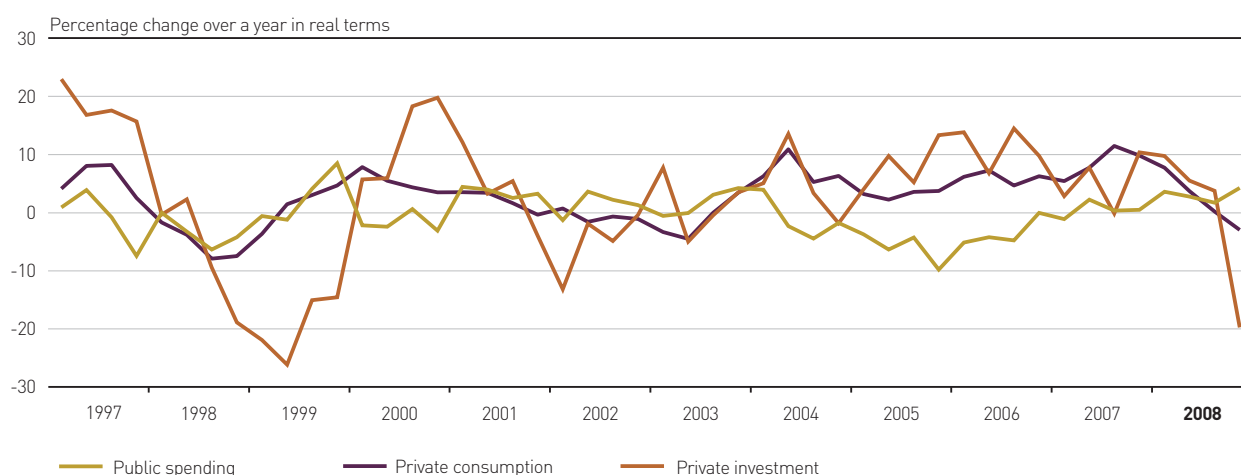
government consumption spending in 2008, which rose by 2% following an increase of 3% in 2007 (Chart 1).

Slowdown in export growth

Hong Kong's export performance deteriorated in 2008, as recessions in the US and other major industrialised economies reduced the external demand from major trading partners. Growth in merchandise exports moderated to 5.1% in 2008 from 9.2% in 2007 in nominal terms. The slowdown in export growth was across the board. Growth in exports to Mainland China declined to

4.7% in 2008 from 13.2% in 2007. Over the same period, exports to the US shrank by 2.4% after contracting by 0.8% in 2007 (Table 2). Because the US and Europe are major final destinations for Hong Kong's exports, there is likely to be a further weakening in the export performance of Hong Kong in 2009 given the economic difficulties faced by those economies. Growth in exports of services also decelerated in the second half of 2008, as the global economic downturn and turbulence in financial markets weighed on offshore trade and external demand for financial services. Meanwhile, imports of goods and

Chart 1 Domestic demand



Source: Census and Statistics Department.

Table 2 Merchandise exports by major trading partners¹

	Share %	2008					2007				
		Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	48	11	8	4	-2	5	13	16	13	11	13
United States	13	-1	-1	1	-7	-2	2	1	-2	-3	-1
European Union	14	8	8	10	-1	6	5	7	6	6	6
Japan	4	-2	-1	3	4	1	2	4	-6	-1	-1
ASEAN ² + Korea	7	15	9	3	11	9	5	11	7	11	9
Taiwan	2	3	7	5	0	4	4	11	-4	-2	2
Others	12	30	24	17	-9	14	14	20	17	20	18
Total	100	10	8	6	-2	5	9	12	8	8	9

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

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

Source: Census and Statistics Department.

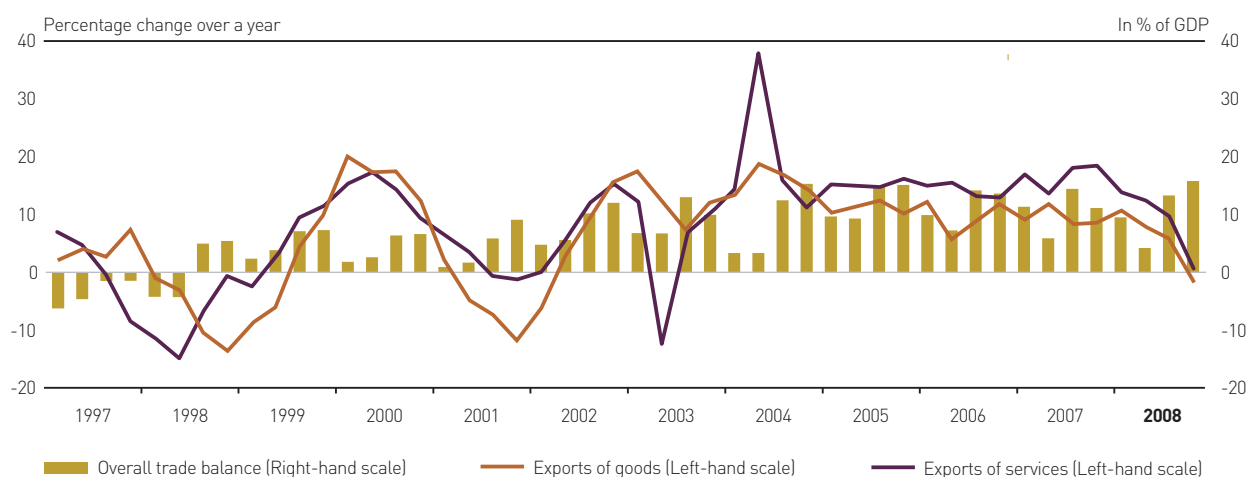
services rose by 6.2% in 2008. Taken together, there was an overall trade surplus of \$182.5 billion (11% of GDP), as against a surplus of \$174.8 billion (also 11% of GDP) in 2007 (Chart 2).

Moderating inflation

Inflationary pressures receded in the second half of 2008 as lower food and commodity prices reduced import-

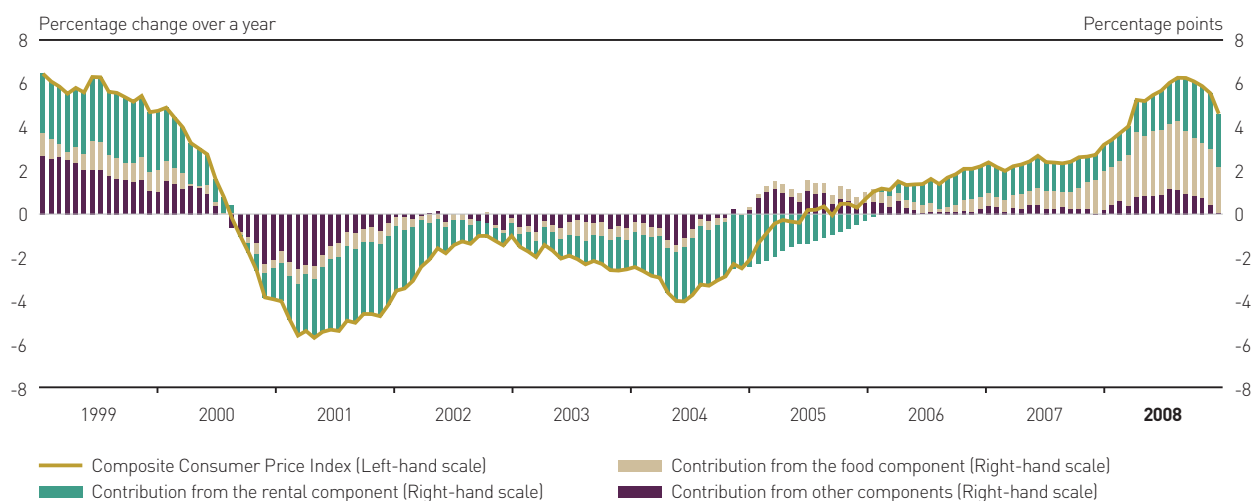
price inflation, while the decline in property prices alleviated rental-cost pressures. After removing the effects of various government relief measures, year-on-year underlying CCPI inflation eased to 4.6% in December from 6.3% in August 2008 (Chart 3). Excluding basic food and energy, core inflation moderated to 4.2% from 4.9% over the same period. For 2008 as a whole, underlying CCPI inflation picked up to 5.6% from 2.8% in 2007, mainly

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



Source: Census and Statistics Department.

Chart 3 Consumer prices¹



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

Sources: Census and Statistics Department, and staff estimates.

Economic and Banking Environment

driven by higher food prices and rental costs. With the stabilisation of food prices in Mainland China and the moderation in market housing rents, consumer price inflation is expected to ease further in the first half of 2009.

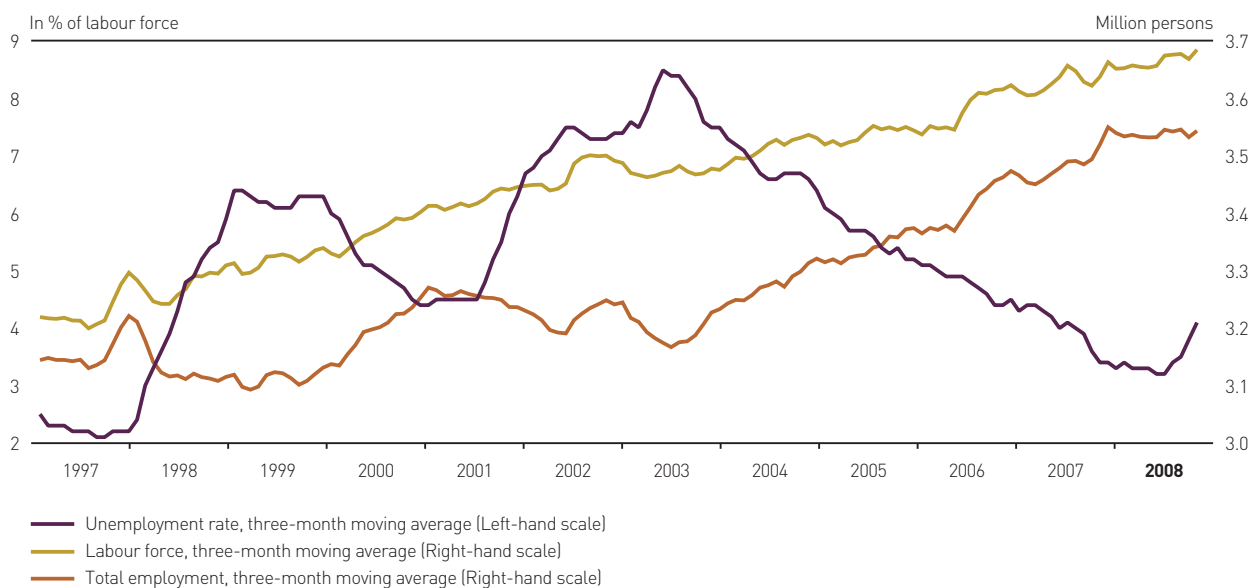
Deteriorating labour market conditions

The slowdown in economic activities and deteriorating business conditions increased the number of unemployed in the fourth quarter of 2008. The unemployment rate rose to 4.1% in December from 3.2% in July (Chart 4). Growth in total employment moderated to 0.7% year on year in the fourth quarter, the slowest pace of expansion since the fourth quarter of 2003. For 2008 as a whole, the unemployment rate declined to 3.6% from 4.0% in 2007, as employment grew faster than the labour force. The near-term employment prospects are likely to deteriorate as business owners streamline their operations and defer their expansion plans in the face of the uncertain economic environment. There have been increased job losses in the import/export and domestic trade sectors, while more layoffs are expected in the financial services sector.

Plummeting stock prices

The bankruptcy of Lehman Brothers and the failure of a number of large financial institutions in the US and Europe triggered a wave of selling in global stock markets, putting downward pressure on domestic equity prices. The Hang Seng Index (HSI) lost nearly half its value during 2008, closing at 14,387 at the end of the year. The decline was across the board, with financial and property-related stocks registering the biggest drop in value, while the H-share index fell more than 50% in 2008. Heightened risk aversion and shattered investor confidence restrained stock market activities, with the average daily turnover shrinking by 18% to \$71.8 billion in 2008. The sharp decline in equity prices drove down the price/earnings ratio of the HSI to 8.5 times at the end of 2008 from 21 times a year earlier. The domestic stock market is expected to remain volatile in the near term given the uncertain global economic outlook.

Chart 4 Labour market conditions



Source: Census and Statistics Department.

Downturn in the property market

The residential property market experienced a marked downturn in the second half of 2008, reversing most of the gains recorded between late 2007 and early 2008. By the end of 2008, house prices declined by 17% and transaction volumes by 54% from June, as tightened credit and worsening economic prospects restrained demand from home buyers. The sharp correction in property prices also exerted downward pressure on rental costs, which declined by 19% for residential property and by 4% for office space between June and December 2008. Increased uncertainty surrounding the economic outlook and less favourable labour market conditions will continue to weigh on property market activity in 2009.

OUTLOOK FOR THE ECONOMY

Slowdown in economic growth

The economic outlook for 2009 has deteriorated. Domestic demand is expected to weaken as rising unemployment and worsening business conditions drag down both household and business spending. Re-export trade and exports of services may slow further in the face of recessions in the economies of our major trading partners. Market consensus suggests that the domestic economy will contract by 3.4% in 2009, as economic activities are likely to decline in the first half of the year. The prospects of a recovery hinge on the duration of the US recession and the resilience of Mainland China's economy in withstanding the recession in developed economies.

Easing inflation and rising unemployment

Consumer price inflation is likely to ease further in 2009 as domestic cost pressures moderate due to weaker aggregate demand. Lower food costs and energy prices will keep import-price inflation in check. Residential rents, which have been a major contributor to inflation, are likely to continue their downward trend in early 2009 following the sharp decline in house prices in 2008. Unemployment may rise, as the weakening external environment and deteriorating business sentiment continue to restrain employment growth.

Uncertainties and risks

There are significant risks to the economic outlook for 2009 as the impact of the global financial crisis on the domestic real sector is still unfolding and the depth and length of recessions in major industrialised economies remain uncertain. Sharper-than-expected recessions in the US and Europe, continuing turbulence in global financial markets and a more visible slowdown in the Mainland economy would deepen and prolong the economic downturn in Hong Kong. Despite this highly uncertain external environment, the domestic economy may weather the current global financial crisis better than the Asian financial crisis in 1997-98. The Asian region, particularly Mainland China, has much stronger economic fundamentals than a decade ago, and policymakers have room for manoeuvre, as demonstrated by the RMB4 trillion fiscal package announced by the Mainland authorities. The ultra loose monetary policy in the US has cushioned the Hong Kong economy under the Linked Exchange Rate system in the current downturn. Policy measures unveiled in the 2008/09 Budget and the supplementary relief measures announced by the Chief Executive in July 2008 have also provided a timely fiscal stimulus to the real economy.

 Publications > Half-Yearly Monetary and Financial Stability Report
 Statistics

Economic and Banking Environment

NOTES AND COINS

At the end of 2008, the total value of banknotes in circulation was \$177.2 billion, an increase of 8.4% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to \$8.1 billion, up 11% (Charts 8 and 9). The value of \$10 notes issued by the Government in circulation (both paper and polymer notes) reached \$2.7 billion, an increase of 30% from 2007.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2008

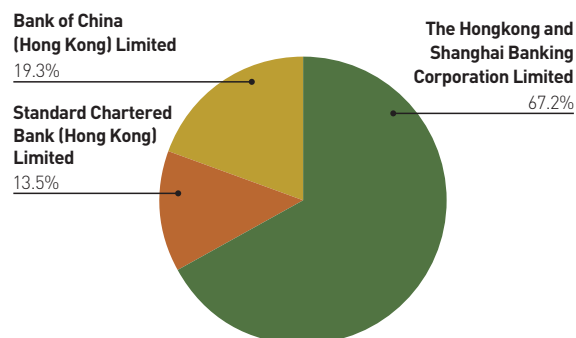


Chart 6 Distribution of banknotes in circulation at the end of 2008

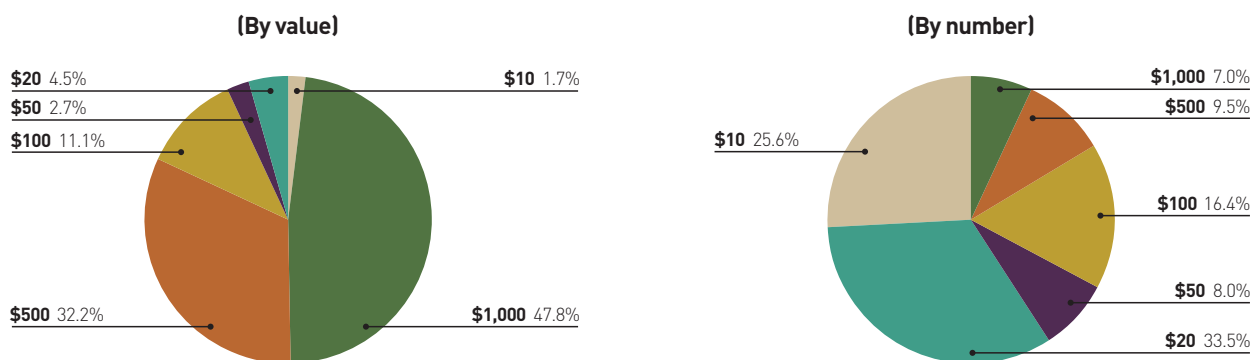


Chart 7 Banknotes in circulation at the end of 2008

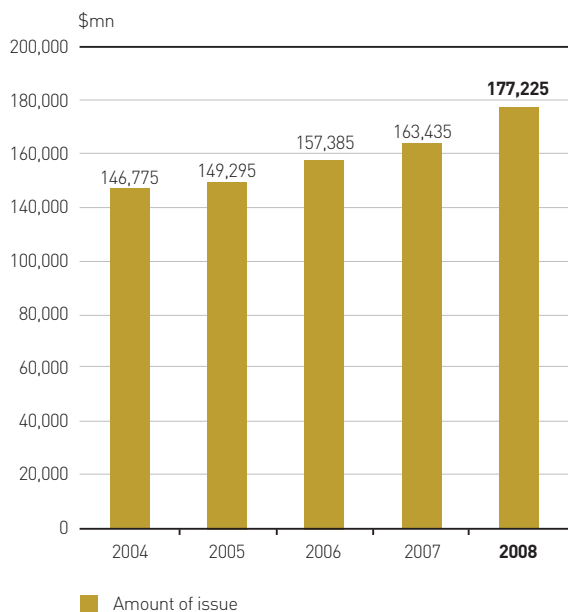


Chart 8 Government-issued notes and coins in circulation at the end of 2008

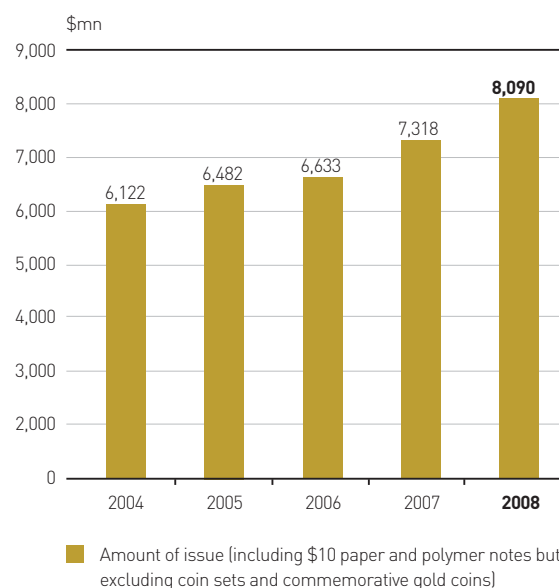
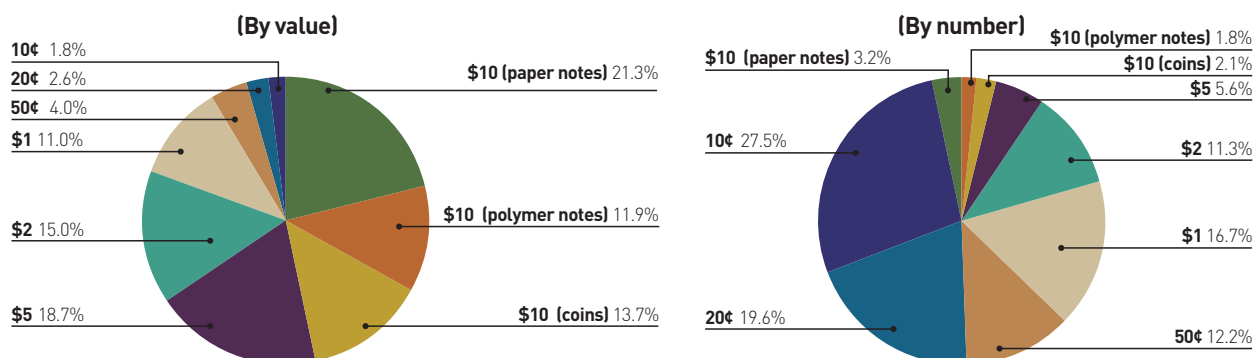


Chart 9 Government-issued notes and coins in circulation at the end of 2008



Hong Kong banknotes

Public education programmes on the security features of the latest series of banknotes issued in 2003 and 2004 continued to be well received. During the year, 31 seminars were organised for over 3,200 bank tellers and retail cashiers, providing them with knowledge and skills for authenticating banknotes.

The HKMA continued its efforts to promote the use of “good-as-new notes”, instead of brand new notes for *lai see* (customary gifts of money given during Chinese New Year). During the year, the HKMA organised a cartoon competition for secondary school students in Hong Kong to promote the use of the “good-as-new notes”. Over 750 students participated.

\$10 polymer note

The Hong Kong \$10 polymer note, which was launched in mid-2007, was in continuous demand. More than 96 million polymer notes were in circulation at the end of 2008, representing 36% of the \$10 notes issued by the Government.

Commemorative Note Issue for the Beijing Olympics

In July four million Bank of China (Hong Kong) Limited \$20 notes commemorating the 2008 Beijing Olympic Games were issued, raising total net proceeds of \$313 million for charitable causes in Hong Kong.

Coin replacement programme

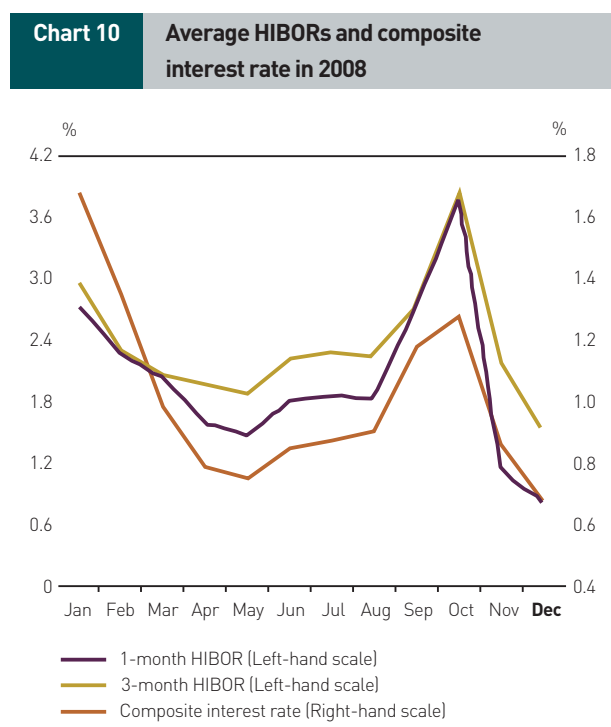
Under the coin replacement programme, 35 million coins bearing the Queen’s Head design were removed from circulation in 2008.

[Consumer Information > Notes and Coins](#)

Economic and Banking Environment

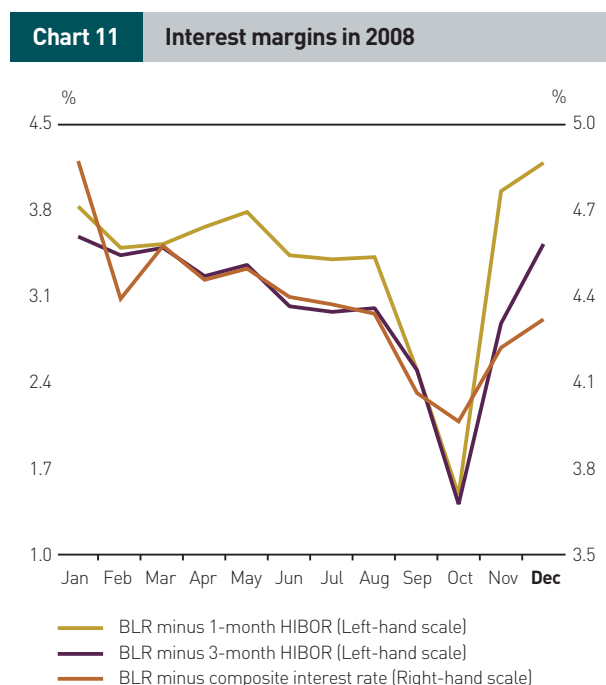
PERFORMANCE OF THE BANKING SECTOR

Despite a challenging year with profits adversely affected by the global financial crisis, the Hong Kong banking sector remained financially sound and well capitalised. Various asset quality indicators remained good by historical standards, although signs of deterioration in a few of the indicators appeared towards the end of the year.



Interest rate trends

In tandem with monetary easing in the US, Hong Kong dollar interest rates fell in the first half of the year. In September the collapse of Lehman Brothers and a brief deposit run on a local bank drove interest rates sharply higher (Chart 10). As a result, the interest margins of banks narrowed significantly (Chart 11). In the fourth quarter, the situation gradually improved following various measures taken by the HKMA to provide liquidity to the banking system.



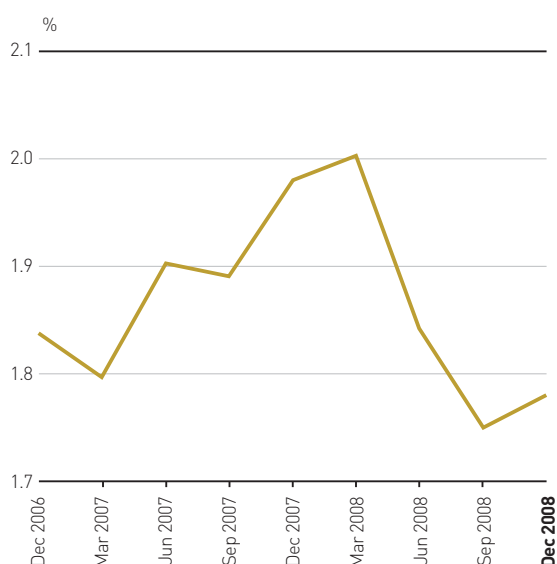
Notes:

- 1 BLR refers to the best lending rate quoted by The Hongkong and Shanghai Banking Corporation Limited (monthly average).
- 2 HIBORs are monthly averages.

Profitability trends

The profitability of retail banks deteriorated during the year. The net interest margin, measured on a quarterly annualised basis, declined from 2.00% in the first quarter to 1.78% in the final quarter (Chart 12). For 2008 as a whole, the net interest margin of retail banks fell to 1.84% compared with 1.90% in 2007 (Chart 13).

Chart 12 Retail banks' net interest margin (quarterly annualised)



The non-interest income of retail banks recorded a sharp decline in 2008. The lacklustre performance of the local stock market and declining wealth management business led to a reduction in fees and commission income. Losses on investments held for trading further reduced retail banks' non-interest income. As a result, the proportion of non-interest income to total income declined to 37.4% from 43.0% in 2007.

On the other hand, the operating costs of retail banks rose by 3.7% in 2008, with the cost-to-income ratio climbing to 45.1% from 40.5% in 2007 (Chart 14).

A deterioration in the business environment and credit downgrades of assets resulted in an increase in provisions. The net charge for debt provisions increased sharply to \$10.7 billion in 2008 from \$2.1 billion a year ago. The net charge for other provisions, most of which relate to impairment allowances for securities holdings, surged to \$14.6 billion from \$4.4 billion in 2007.

Chart 13 Retail banks' net interest margin (yearly)

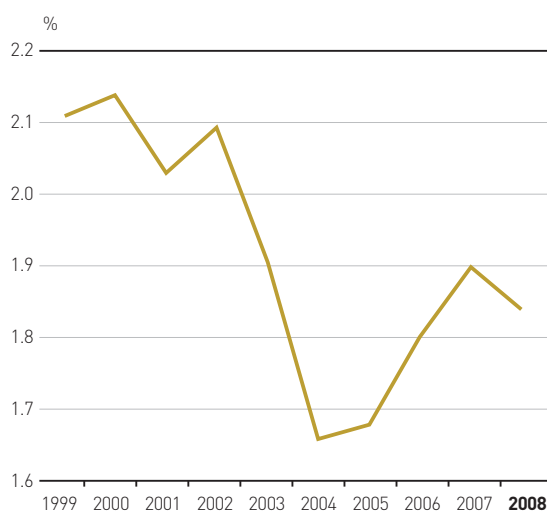
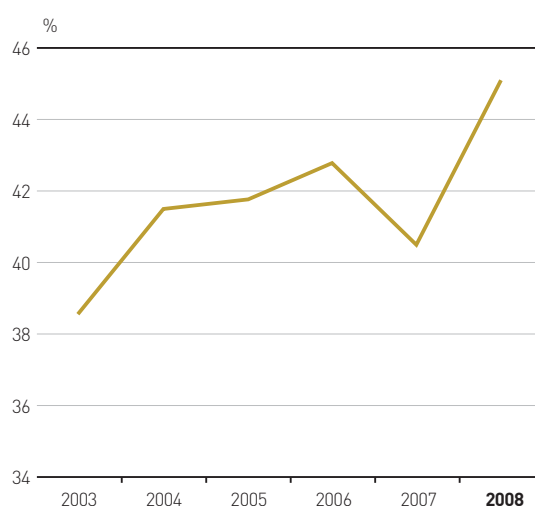


Chart 14 Retail banks' cost-to-income ratio



Economic and Banking Environment

As a result of lower income and increased provisions, the aggregate pre-tax operating profits of retail banks' Hong Kong offices fell substantially by 35.7% in 2008 compared with 2007 (Chart 15). The post-tax return on average assets declined to 0.85% in 2008 from 1.48% a year earlier (Chart 16).

Chart 15 Retail banks' year-on-year growth in operating profit before tax

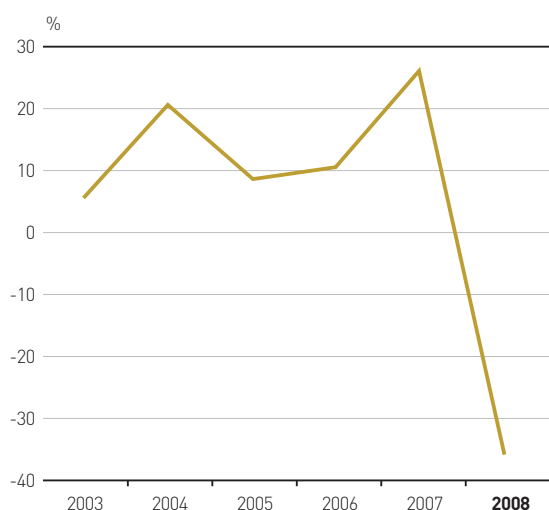
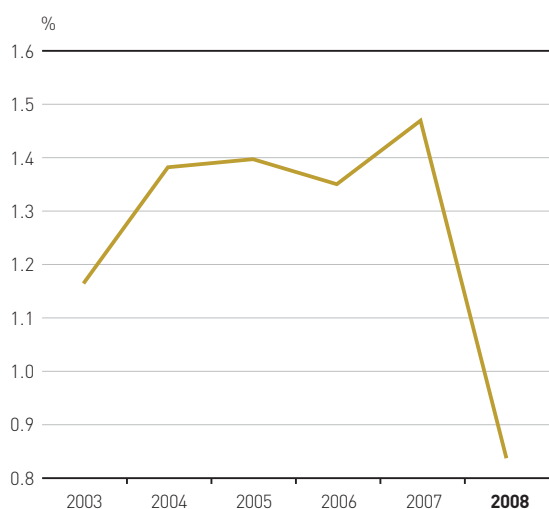


Chart 16 Retail banks' return on assets (after-tax profit)



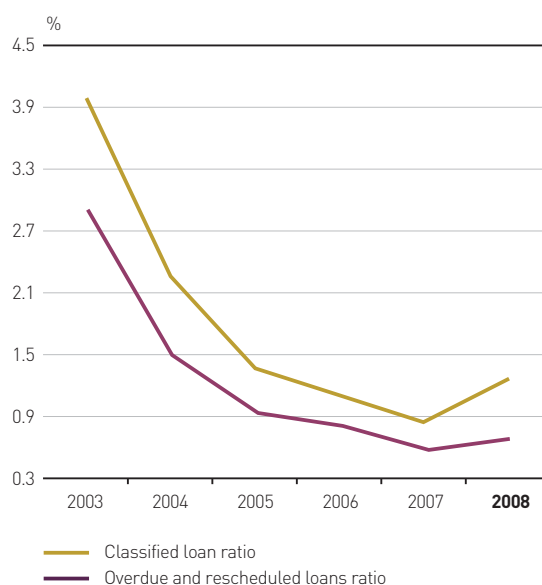
Asset quality

The asset quality of retail banks remained good by historical standards, but a few indicators showed signs of deterioration. The combined ratio of overdue and rescheduled loans increased to 0.68% at the end of 2008 from 0.57% a year earlier. The classified loan ratio increased to 1.24% from 0.85% in 2007 (Chart 17).

The quality of non-bank China exposures also deteriorated. The classified loan ratio for retail banks' Mainland banking subsidiaries rose to 0.98% in 2008 compared with 0.36% in 2007.

The financial crisis, which originated in the US and spread rapidly to Europe and Asia, weighed heavily on the quality of retail banks' debt securities holdings. The amount of securities classified as "special mention" increased to about 0.39% of retail banks' total assets at the end of 2008 from 0.09% a year earlier. Debt securities classified as "sub-standard", "doubtful" or "loss" represented about 0.06% of retail banks' total assets, compared with 0.04% in 2007.

Chart 17 Asset quality of retail banks



The quality of retail banks' residential mortgage lending remained strong. The delinquency ratio declined to 0.05% from 0.11% in 2007 (Chart 18). The rescheduled loan ratio declined to 0.14% from 0.20% in 2007. As a result, the combined ratio of delinquent and rescheduled loans fell to 0.19% from 0.31% in 2007. As property prices declined, however, the outstanding number of residential mortgage loans in negative equity rose to 10,949 at the end of 2008 from 1,861 in 2007.

The results of the credit card survey indicated that the quality of the surveyed institutions' credit card lending remained stable in 2008. The delinquency ratio declined slightly to 0.34% from 0.35% in 2007 (Chart 18). The combined delinquent and rescheduled ratio fell to 0.41% from 0.42% in 2007. The charge-off ratio also fell to 2.72% from 2.90% at the end of 2007.

It should be noted, however, that the quality of credit card and mortgage lending is highly correlated with employment conditions. If the unemployment rate continues to rise, the delinquency ratios of credit card and mortgage lending may reverse their declining trends of the past few years.

[Press Releases > Residential Mortgage Survey](#)

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

Balance sheet trends

Total loans and advances by retail banks increased by 10.6% in 2008, while total customer deposits increased by 6.6%. The overall loan-to-deposit ratio of retail banks rose to 47.2% from 45.5% in 2007. The Hong Kong dollar loan-to-deposit ratio rose to 69.4% from 65.1% a year earlier (Chart 19).

Chart 18 Delinquency ratios of residential mortgages and credit card lending of surveyed institutions

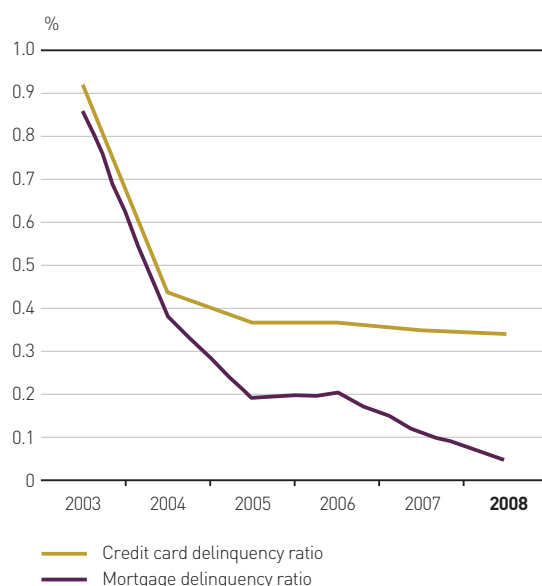
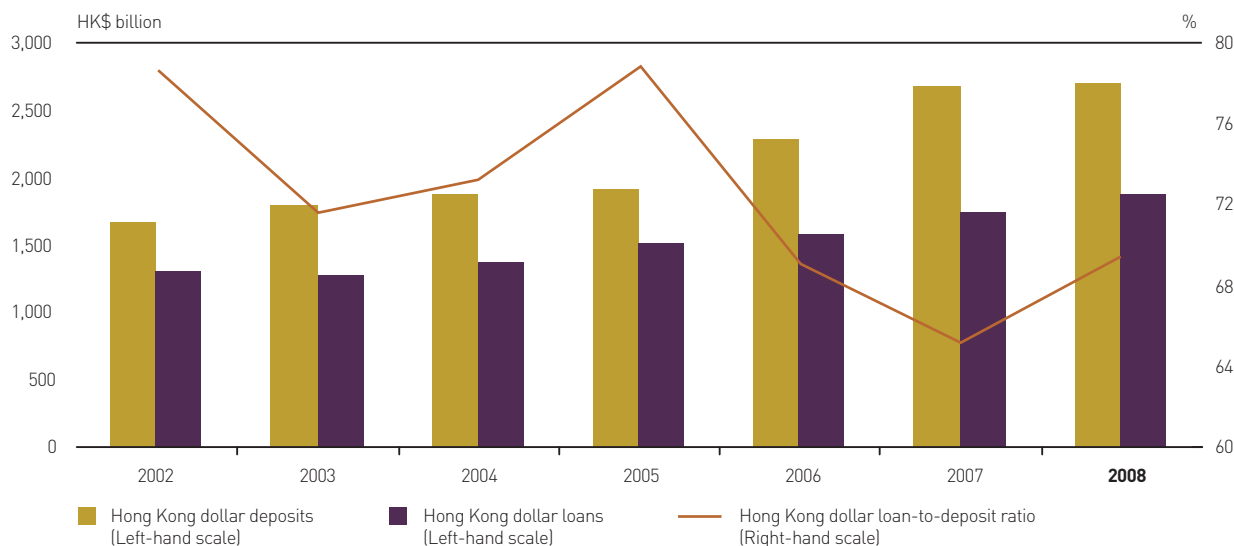


Chart 19 Retail banks' Hong Kong dollar loans and customer deposits



Economic and Banking Environment

The changes in retail banks' loans for use in Hong Kong by selected economic sectors are shown in Chart 20. Lending to the manufacturing sector and the wholesale and retail sector grew markedly by 22.9% and 27.4% respectively.

Retail banks' total non-bank China exposures¹ rose to \$644 billion at the end of 2008 from \$568 billion a year earlier. For the banking sector as a whole, non-bank China exposures rose to \$858 billion from \$774 billion at the end of 2007.

Holdings of negotiable debt instruments

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, increased by 18% in 2008. Of those NDIs, 45% were issued by corporates, compared with 55% in 2007. A flight to quality drove the proportion of government-issued NDIs higher to 32% from 23% in 2007. The proportion of NDIs

issued by banks increased slightly to 23% from 22% in 2007 (Chart 21). The share of retail banks' total holdings of NDIs relative to their total assets increased to 22% at the end of 2008 from about 20% a year ago.

Chart 21 Retail banks' holdings of negotiable debt instruments at the end of 2008 (issuer breakdown)

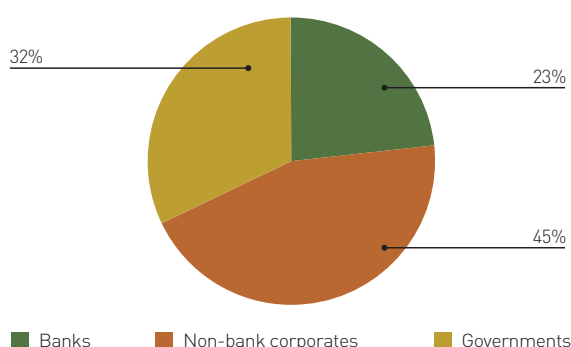
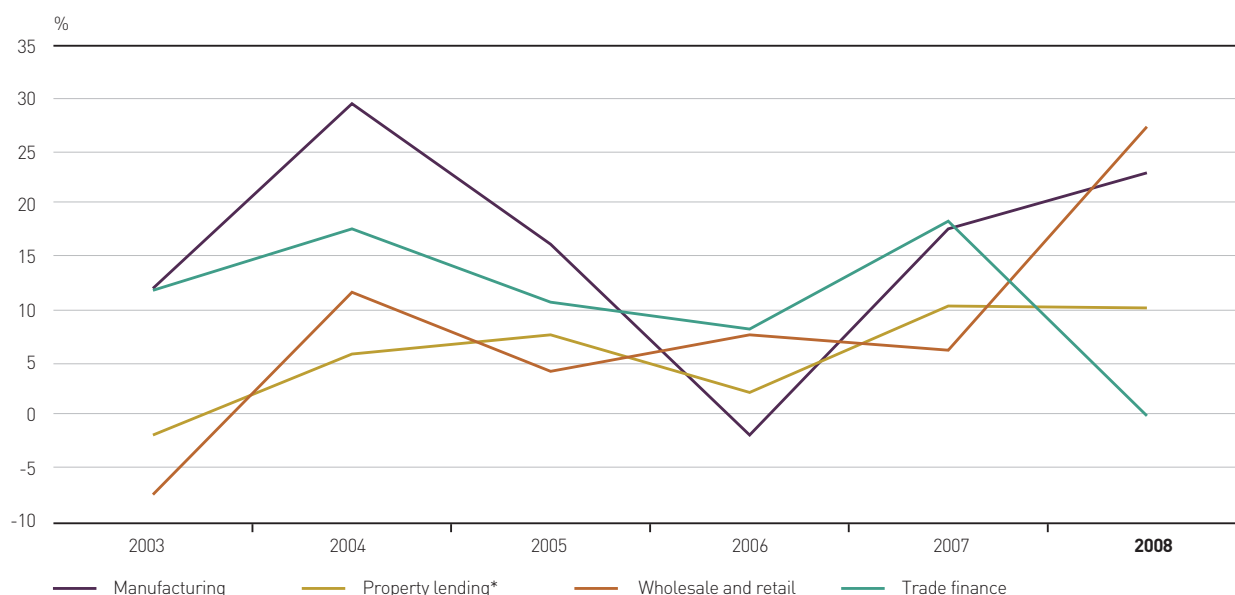


Chart 20 Retail banks' loans for use in Hong Kong by selected sectors (year-on-year growth)



* Property lending denotes lending for property development and investment, and residential mortgage loans (excluding lending under the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme).

¹ Including exposures booked in retail banks' banking subsidiaries in Mainland China.

Capital adequacy and liquidity

The capital positions of locally incorporated Als generally remained sound despite the difficult operating environment. The consolidated capital adequacy ratio of all locally incorporated Als rose to 14.8% at the end of 2008 from 13.4% a year ago. Tier-1 capital ratio increased to 11.2% at the end of 2008 from 10.4% in 2007 (Chart 22).

Retail banks generally remained liquid in 2008. In spite of the worsening global financial crisis, the quarterly average liquidity ratio of retail banks stood at 45% in the final quarter of 2008, well above the statutory minimum of 25% (Chart 23).

PROSPECTS FOR 2009

The operating environment remained difficult in the early part of 2009 and is likely to remain so for much, if not all, of the year. The global financial crisis will continue to affect the domestic economy. The asset quality of banks may deteriorate further, and banks may need to make greater provisions for bad and doubtful debts. Demand for investment products will remain subdued following the collapse of Lehman Brothers, which triggered numerous complaints about the sale of Lehman-related investment products to retail investors. This may result in a shift of focus from wealth management to traditional deposit-taking and lending business. Despite continued pressure on profitability, the banking system should be well positioned to meet the challenges in 2009.

Chart 22 Consolidated capital adequacy ratio of locally incorporated Als

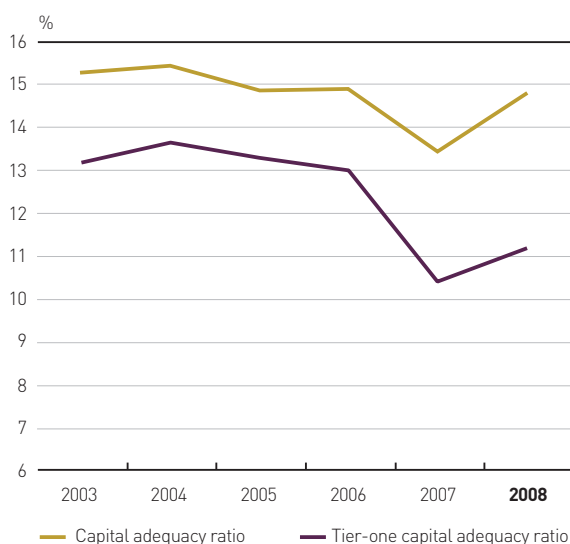
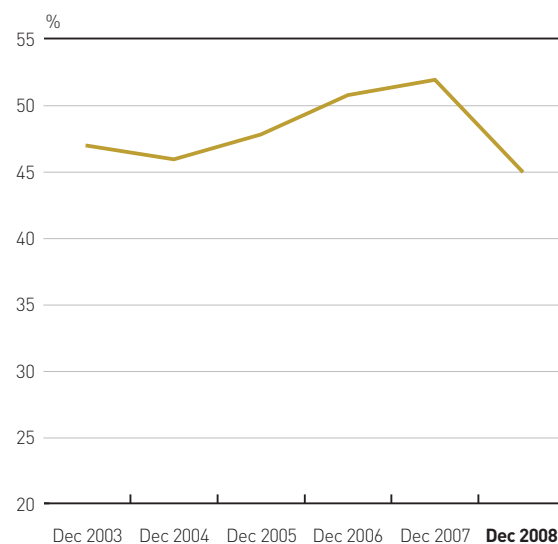


Chart 23 Retail banks' liquidity ratio (quarterly average)



Monetary Stability

The Hong Kong dollar remained stable against the US dollar despite the global financial crisis. To relieve stress in the money market, the HKMA introduced measures to increase liquidity and reduce borrowing costs. These measures helped restore normal functioning of the interbank market and mitigate the impact of credit tightness on the wider economy.

OBJECTIVES

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

The Monetary Base (Table 1) comprises

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

 Monetary Base

Table 1	Monetary Base	
\$ million	31 Dec 2008	31 Dec 2007
Certificates of Indebtedness ¹	177,225	163,435
Government-issued currency notes and coins in circulation ¹	8,319	7,547
Balance of the banking system	158,038	10,639
Exchange Fund Bills and Notes issued ²	163,554	138,369
TOTAL	507,136	319,990

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

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

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism as well as the firm commitment by the HKMA to honour the Convertibility Undertakings (CUs). When the demand for Hong Kong dollars is greater than supply and the market exchange rate strengthens to the strong-side CU of HK\$7.75 to the US dollar, the HKMA stands ready to sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then expand to push down Hong Kong dollar interest rates, creating monetary

conditions that move the Hong Kong dollar away from the strong-side limit to within the Convertibility Zone of 7.75 to 7.85. On the other hand, if the supply of Hong Kong dollars is greater than demand and the market exchange rate weakens to the weak-side CU of HK\$7.85 to the US dollar, the HKMA will buy Hong Kong dollars from banks. The Aggregate Balance will then contract to drive Hong Kong dollar interest rates up, pushing the Hong Kong dollar away from the weak-side limit to stay within the Convertibility Zone.

 Monetary Stability > Currency Board System

Monetary Stability

REVIEW OF 2008

Exchange rate stability

Currency stability in Hong Kong held up well during the year. The Hong Kong dollar market exchange rate traded within a narrow range of 7.7710 and 7.8139 in the first eight months, despite the strengthening of the renminbi, inflationary pressures in the local economy and increased volatility in financial markets (Chart 1). The market remained calm when the renminbi appreciated beyond the psychological level of RMB7 to the US dollar in April. This suggests that the HKMA was successful in managing market expectations to address speculation that the Hong Kong dollar would follow the appreciation of the renminbi.

In mid-September, the US Government's decision not to rescue the investment bank Lehman Brothers sent shock waves through global financial systems and made currency markets extremely volatile. Major currencies (except for the Japanese yen) reversed their early

strength and depreciated sharply against the US dollar, partly reflecting concerns about narrowed interest-rate differentials against the US dollar. Under the Linked Exchange Rate system (LERS), the Hong Kong dollar also strengthened, appreciating against the Australian dollar, the Korean won, the British pound and the euro by over 20% between July and November.

The Hong Kong dollar spot exchange rate quickly strengthened towards the strong-side CU in September and October, and stayed near 7.75 thereafter. The strong-side CU was repeatedly triggered between 31 October and 31 December, prompting the HKMA to passively sell Hong Kong dollars against US dollars at HK\$7.75 to the US dollar.

Chart 1 Market exchange rate, January-December 2008

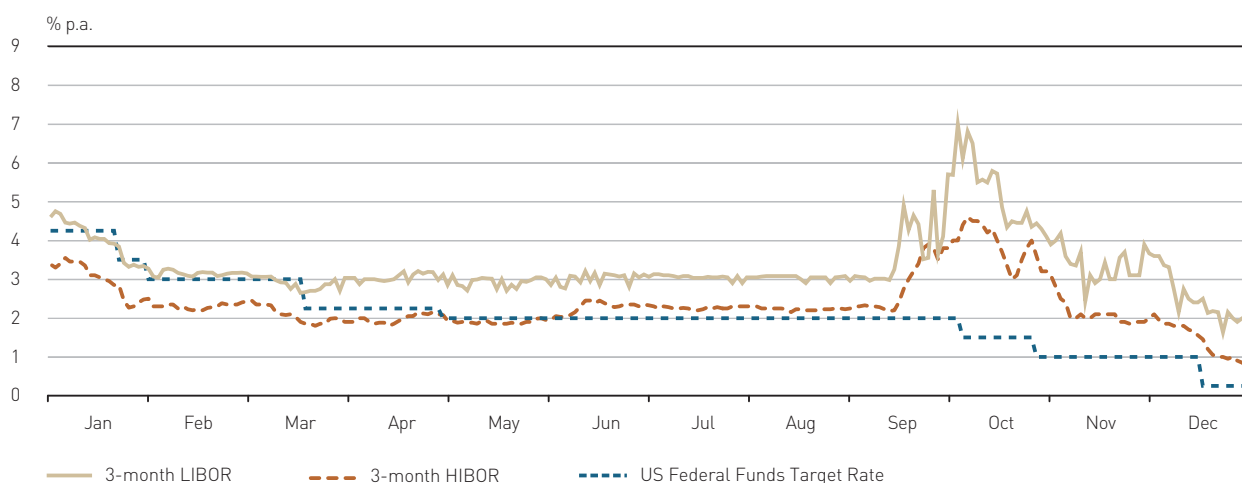


There were several reasons for the strengthening of the Hong Kong dollar. First, market participants unwound their earlier Hong Kong dollar-funded carry-trade positions as the worsening global financial crisis and credit tightening led them to de-leverage and reduce their exposure to risk. Secondly, business and liquidity needs as a result of tightened credit and decreases in financial asset prices prompted some domestic corporations to repatriate their funds into Hong Kong dollars. Other possible reasons included a flight to a safe haven, foreign banks swapping US dollars for Hong Kong dollars, and demand from investors reportedly positioning for a possible rebound in the local asset markets.

Money market

Between January and August, activities in Hong Kong's money market were generally smooth and orderly. The HKMA raised the supply of three-month Exchange Fund Bills through a tap issue on 11 January to meet increased market demand arising from banks' intraday liquidity needs.¹ The HK\$6 billion worth of additional Bills was well received by market participants. In the interbank market, Hong Kong dollar interest rates generally declined in the first four months of 2008 along with their US dollar counterparts as the US Federal Funds Target Rate was lowered by a total of 225 basis points (Chart 2). The one-month and three-month HIBORs rose in late May and June, partly because of worries about the deteriorating global macroeconomic outlook and its associated negative impact on money markets. From May to August, the overnight HIBOR gradually climbed despite overnight LIBOR being largely stable, possibly due to tighter funding conditions associated with increases in the Hong Kong dollar loan-to-deposit ratio (Chart 3).

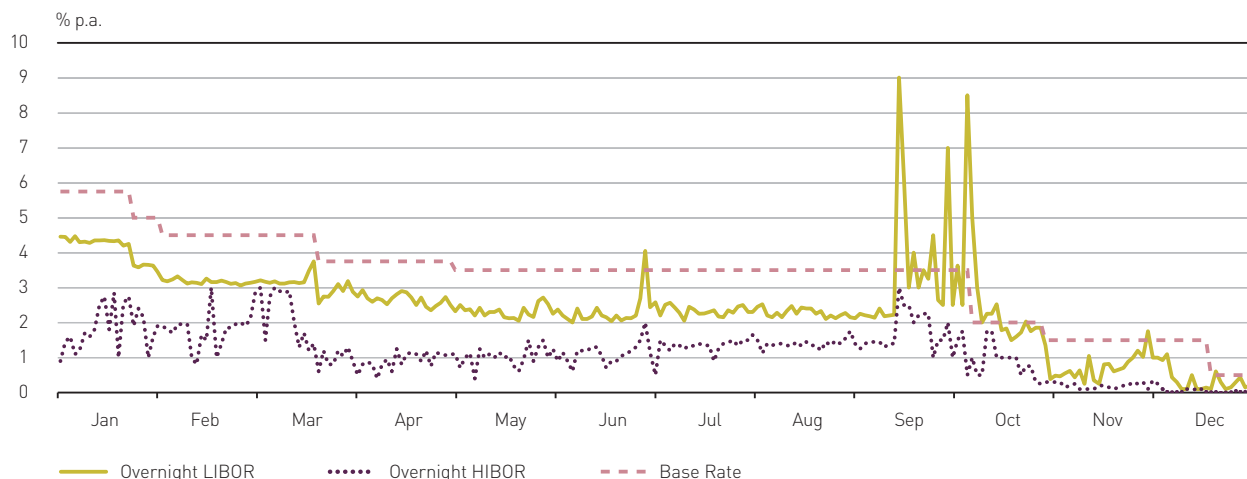
Chart 2 Hong Kong dollar and US dollar interest rates, January–December 2008



¹ From September to December 2007, the demand for short-dated Exchange Fund paper increased alongside a rise in equity market transactions. As banks need to hold Exchange Fund papers as collateral for repurchase arrangements with the HKMA, the demand for such papers increased along with the heightened demand for intraday liquidity due to rapidly growing interbank transactions.

Monetary Stability

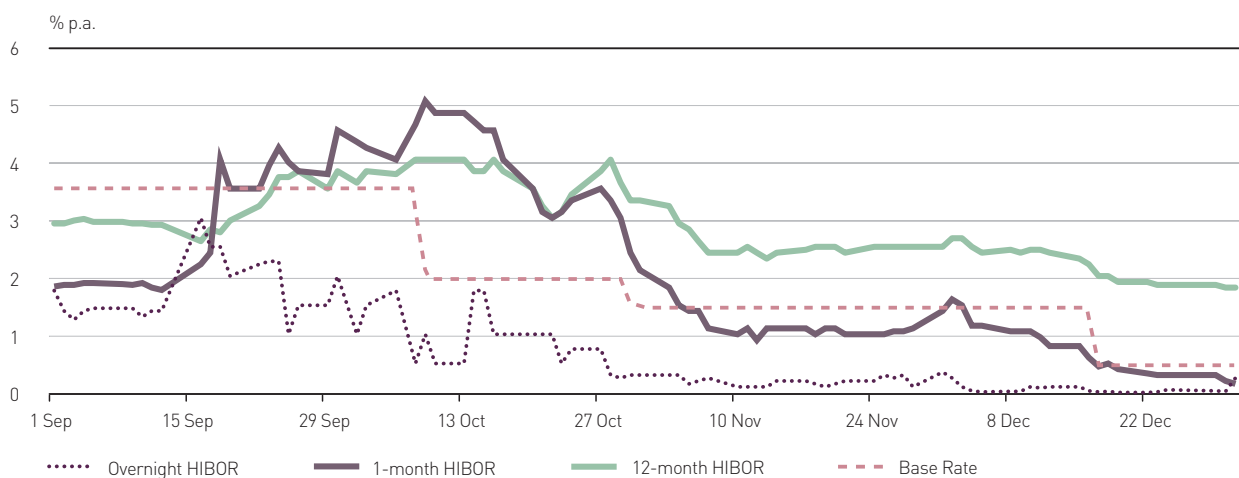
Chart 3 Hong Kong dollar and US dollar interest rates, January–December 2008



Following the collapse of Lehman Brothers in mid-September, global financial markets seized up and entered a new crisis-of-confidence phase. Heightened concern about the credit worthiness of counterparties, coupled with a desire to preserve liquidity to meet contingencies, led to a general shortage of interbank liquidity locally and difficulties on the part of individual licensed banks in obtaining funding in the interbank

market. As a result, banks began to refrain from lending to each other and Hong Kong dollar interbank interest rates increased sharply in tandem with US dollar counterparts (Charts 2, 3 and 4). Interest rate volatility also rose, and the HIBOR-LIBOR differentials fluctuated sharply, with discounts occasionally turning into premia suggesting the interbank market was not functioning normally.

Chart 4 Hong Kong dollar interest rates, September–December 2008



On 24 September a small-scale run on a local bank led to further tightness in the domestic money market. The mini-run was caused by unfounded rumours, spread by text messages, about the bank's financial soundness. Other banks became concerned that possible withdrawals by nervous depositors might increase pressure on their funding despite their sound fundamentals. At around the same time, an unusually strong demand from banks for Exchange Fund paper for liquidity management purposes drove the implied yields of short-dated Exchange Fund paper to very low levels or below zero, resulting in a divergence between interbank interest rates and the yields of the corresponding Exchange Fund paper.

Responding to the stress in the interbank market, the HKMA announced a series of temporary measures to help contain liquidity and solvency risks in the domestic banking system.

Liquidity provision

First, the HKMA injected liquidity into the banking system. In view of the sharp increases in HIBORs and the potential fragility of banking confidence caused by a small-scale local bank run, the HKMA operated within the Convertibility Zone on 18 and 25 September to inject liquidity into the banking system, purchasing US dollars against Hong Kong dollars (Table 2). As the term HIBORs showed signs of renewed tightness in late October on concerns about the financial problems of certain emerging markets, the HKMA carried out three more within-zone foreign exchange operations, one on 23 October and two on 27 October. These proactive operations, together with the repeated triggering of the strong-side CU, increased the supply of liquid funds in the banking system and relieved the tightness in the interbank market.

Table 2 Foreign exchange operations by the HKMA, September–December 2008

		Total amount of HK dollar sold (HK\$ million)	Total amount of US dollar bought (US\$ million)
Within-zone operation		28,818	3,715
– proactive liquidity injection into the banking system	(i)	24,822	3,200
– offsetting operation associated with additional supply of Exchange Fund Bills	(ii)	3,996	515
Triggering of the strong-side CU	(iii)	153,977	19,868
Total		182,795	23,583

(i) Once on 18 September, 25 September and 23 October, and twice on 27 October.

(ii) On 20 October.

(iii) Between 31 October and 31 December.

These dates refer to the trade days of the transactions.

Monetary Stability

Consequently, the Aggregate Balance increased to \$158.0 billion on 31 December, exceeding the record high of around \$55.0 billion in 2004 when the market speculated on the strengthening of the Hong Kong dollar alongside the appreciation of the renminbi (Chart 5). Earlier, the Aggregate Balance had declined from around \$10.6 billion at the beginning of 2008 to \$4.7 billion on 14 January because of the tap issue of Exchange Fund paper, and stayed at around this level until mid-September.

Secondly, the HKMA introduced five temporary measures on 30 September to provide individual banks in need with collateralised liquidity, through or outside the Discount

Window (Table 3). As a result of these backstop liquidity facilities, banks were more assured about the availability of funds, and therefore more willing to lend in the interbank market. The HKMA also introduced on 6 November two refinements to collateralised term lending, extending the maximum tenor from one month to three months and introducing scope for lending at a rate lower than the interbank interest rate. The total amount of liquidity provided by these five temporary measures was initially at a high of \$11.4 billion at the end of October. As the situation in the interbank market stabilised, the amount dropped to about \$6.2 billion at the end of November and \$6.1 billion at the end of December.

Chart 5 Aggregate Balance, January–December 2008

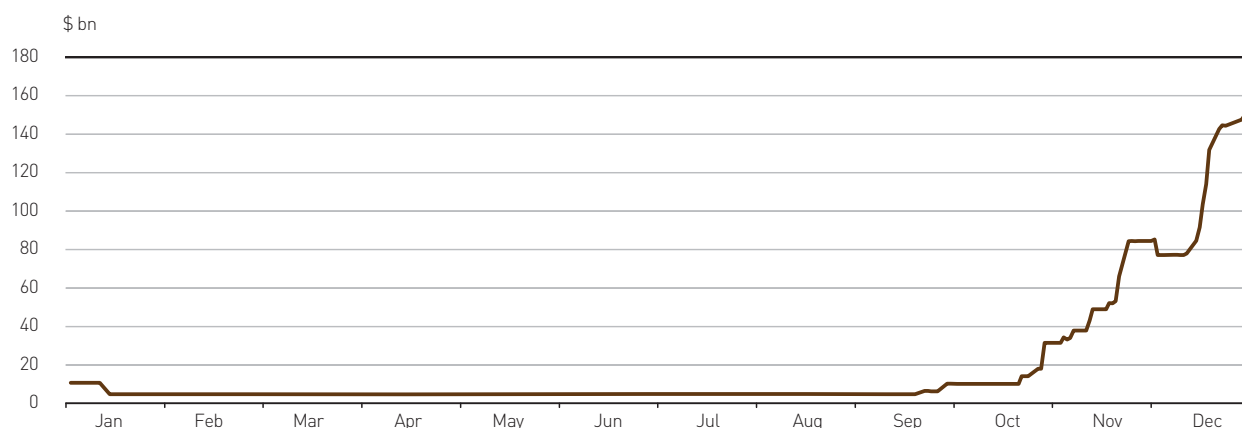


Table 3 Liquidity assistance to licensed banks in Hong Kong: five temporary liquidity measures announced on 30 September

(i) Wider scope of collateral under the Discount Window

Expanding eligible securities under the Discount Window to include US dollar assets of credit quality acceptable to the HKMA

(ii) Term Discount Window borrowing

Extending the term of the liquidity provided through the Discount Window from overnight to maturities up to three months

(iii) Lower interest rate at the Discount Window

Waiving the penalty rate for using over 50% of the Exchange Fund paper holding in accessing the Discount Window

(iv) Foreign exchange swaps

Conducting foreign exchange swaps (between US dollars and Hong Kong dollars of various durations) with individual licensed banks when necessary

(v) Term lending against collateral

Lending term money to individual licensed banks against acceptable collaterals when necessary, and interest rate for such lending determined with reference to market interest rates

On 14 October the Financial Secretary announced two precautionary measures to bolster public confidence in the banking system: a temporary 100% deposit guarantee and a contingent capital facility for banks. These measures were designed to stabilise the banks' deposit base as a source of funding over the next two years and provide comfort to banks on the availability of additional capital, thereby helping to restore the normal functioning of the interbank market.

Exchange Fund Bills and Notes also form a part of the liquidity in the banking system since they can be used for borrowing through the Discount Window or sold in the market for cash. To satisfy increased demand and further improve banks' access to the various newly-introduced liquidity facilities, the HKMA announced on 20 October the issuance of \$4 billion of additional three-month Exchange Fund Bills in tenders on 28 October and 4 November. A foreign exchange operation, purchasing US dollars against Hong Kong dollars, was carried out by the HKMA on the announcement day to help maintain the prevailing level of liquidity in the banking system (Table 2).² Later, the HKMA announced on 24 November another issuance of \$8 billion of additional three-month Exchange Fund Bills in a tender on 2 December.

Thirdly, the HKMA lowered the price of liquidity by temporarily adjusting the formula for determining the Discount Window Base Rate on 9 October, effectively reducing banks' borrowing cost of liquidity from the HKMA.³ As the US Federal Funds Target Rate was lowered from 2% to 0-0.25% in the last quarter of 2008, the Base Rate declined from 3.5% in September to a record low of 0.5% at the end of December.

Effectiveness of the temporary measures

Following the introduction of these measures, the interbank credit market generally stabilised and local interbank rates declined across the board. The overnight HIBOR eased to 0.3% at the end of December after rising to an intraday high of 4% on 18 September, and the one-month HIBOR retreated to 0.2% from an intraday high of 6% over the same period. The 12-month HIBOR also declined to below 2% as a result of the much larger Aggregate Balance towards the end of 2008 (Chart 4). Efforts around the world to provide liquidity to the markets, coupled with an improvement in market sentiment, also helped the recovery of the wholesale funding market.

As the strong-side CU was repeatedly triggered, Hong Kong dollar liquidity injections by the HKMA created an opportunity to provide an accommodative monetary environment to support general economic activity. The easing of wholesale interbank interest rates should, in due course, trickle down to interest rates at the retail and corporate levels, helping borrowers better overcome the challenges posed by the current economic difficulties.

The integrity of the rule-based Currency Board system

After 25 years of operation, the LERS has continued to work smoothly, even in the face of the once-in-a-century financial crisis, as the Government continues to be firmly committed to the system. The market continues to show strong confidence in the LERS demonstrated by the absence of speculative pressures on the exchange rate in the financial market turmoil during the latter half of 2008.

² The combination of the additional supply of Exchange Fund paper and the within-zone foreign exchange operation is technically a transfer of different components of the Monetary Base among themselves, which is consistent with the Currency Board principles.

³ With effect from 9 October 2008, the formula for determination of the Base Rate was changed by reducing the spread of 150 basis points above the prevailing US Federal Funds Target Rate to 50 basis points. The other leg relating to the moving averages of the relevant interbank interest rates was removed from the formula. These changes would be reviewed by 31 March 2009.

Monetary Stability

The Aggregate Balance, and hence the Monetary Base, expanded markedly during 2008 as a result of both the operation of the HKMA within the Convertibility Zone and the triggering of the strong-side CU (Table 1). These operations were in line with Currency Board principles, with changes in the Monetary Base fully matched by changes in foreign reserves. The foreign-currency assets of the Exchange Fund amounted to HK\$1.4 trillion at the end of 2008, more than enough for backing the Monetary Base.

Over the years, the structure of the Currency Board has become more transparent and stronger. To improve the transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998. In 2008 following an asset transfer in January, the Backing Ratio (defined as the Backing Assets over the Monetary Base) increased to a high of 111.88% on 21 September. Subsequently, there were moderate downward pressures on the Backing Ratio, first as a result of a transitory increase in Certificates of Indebtedness in September and subsequently because of increases in the Aggregate Balance.^{4 & 5} The Backing Ratio closed at 109.73% on 31 December.

Activities at the HKMA

The EFAC Currency Board Sub-Committee, established in August 1998, monitors and reviews issues pertinent to monetary and financial stability in Hong Kong. In 2008 these issues included the pass-through of changes in exchange rates to domestic inflation in Hong Kong, the effects of rising food prices in Asia and their implications for monetary policy, the impact on the interbank market of the fund-raising activities for initial public offerings in the Hong Kong stock market, and the determinants of Hong Kong dollar swap spreads. Records of discussion

of the Sub-Committee on these issues and the reports on Currency Board operations submitted to the Sub-Committee are published on the website of the HKMA.

The Sub-Committee also considered a review of the Report on Currency Board Operations and agreed that the Report should be published quarterly from the beginning of 2009. The reasons for this are that the statistical data contained in the Report are all published elsewhere, including on the HKMA website, monthly and sometimes daily; market practitioners are now much more familiar with the operation of the Currency Board than when the Report was conceived; and to allow more analysis and comment to be provided in the Report. The Sub-Committee noted that, because all data in the current Report were published elsewhere at least as frequently, this would not lead to any reduction in the transparency of the operations of the Currency Board.

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

The Hong Kong Institute for Monetary Research, established in August 1999, continued to sponsor research in the fields of monetary policy, banking and finance. In 2008 the Institute hosted 16 full-time and two part-time research fellows, and four post-doctoral fellows. It also published 25 working papers.

The Institute co-organised three international conferences. The first, held on 21 January with the Bank for International Settlements (BIS), discussed financial integration and co-operation in Asia. The second, held on 26-27 June with the Center for Pacific Basin Studies of the Federal Reserve Bank of San Francisco, Santa Cruz Center for International Economics, the University of Hong Kong and Lingnan University, examined global liquidity and its economic implications. The third, held on

⁴ The Backing Ratio rose to 112.53% and surpassed 112.5% (defined as the Upper Trigger Level) on 21 January 2008, under the influence of interest income and revaluation gains which more than offset the effect of an increase in the Aggregate Balance in late October 2007. Under the arrangements approved by the Financial Secretary in 2000, a portion of the Backing Assets was then transferred to the Investment Portfolio, restoring the Backing Ratio to around 110% on 22 January 2008.

⁵ The expansion in the Aggregate Balance exerted a downward influence on the Backing Ratio because while the Backing Assets rose by the same magnitude as the Monetary Base (as required under the Currency Board arrangements), the proportional increase was smaller in the former due to its larger size.

18-19 September with the BIS, dealt with the issues of the microstructure of financial markets. On 16-17 October the Institute organised jointly with the Wang Yanan Institute for Studies in Economics of the Xiamen University a workshop entitled "Efficiency and Stability of the Financial System in Mainland China". Other programmes included the Sixth Annual Summer Workshop on 28 August, and a presentation on the Global Financial Crisis co-hosted with the Asian Development Bank on 11 December. In addition to conferences and workshops, 40 public seminars were organised during the year on a broad range of economic and monetary issues.

 Research

PLANS FOR 2009 AND BEYOND

Hong Kong continues to be affected by the global financial crisis and the external environment remains highly challenging. The HKMA stands ready to provide more liquidity to the banking system if necessary, through foreign exchange operations within the Convertibility Zone, as long as exchange-rate stability is not affected. Externally, movements in the US dollar are volatile. A sudden reversal of Hong Kong dollar inflows could affect monetary and financial stability in Hong Kong.

The HKMA will monitor risks and vulnerabilities in the domestic and external environment and continually assess the effectiveness of the temporary measures taken since September 2008. It will help to ensure the financial system of Hong Kong performs the important function of financial intermediation, and provide an accommodative monetary environment to support economic activity as long as exchange-rate stability is maintained. The EFAC Currency Board Sub-Committee will examine issues relevant to Hong Kong's monetary and financial stability, review the technical aspects of the Currency Board arrangements and, where appropriate, recommend measures to strengthen them.

Banking Stability

Ensuring Hong Kong's authorized institutions were well capitalised and adequately liquid to face the challenges of the global financial crisis was a priority for the HKMA in 2008. Following the collapse of Lehman Brothers in mid-September, measures were introduced to provide liquidity assistance to banks and restore confidence in the banking system. The local banking sector remained resilient. Substantial resources were deployed to handle the alleged mis-selling of Lehman Brothers-related investment products by banks. A number of international initiatives are being implemented in Hong Kong to address the lessons from the current crisis.

OBJECTIVES

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

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

REVIEW OF 2008

Risk-based supervision

The HKMA's risk-based supervisory process was further strengthened to keep pace with developments in the banking industry. Substantial resources were devoted to conducting thematic and specialised examinations and issuing guidelines on industry best practices covering selected lines of business and major risk areas to assist Als in improving their risk management and internal controls.

During the year, two specialist credit risk teams were established to carry out examinations reviewing Als' best practices in commercial and consumer lending, with a particular focus on syndicated lending, residential mortgage loans, personal loans and share margin financing.

Because of the redeployment of considerable internal resources to investigate the alleged mis-selling of Lehman Brothers-related investment products by banks since mid-September, the HKMA conducted 161 on-site examinations in 2008, compared with 246 in 2007. As the financial crisis continued to unfold, the HKMA also deployed resources to conduct in-depth reviews of Als' exposures to financial groups or banks in difficulty and financial instruments with significant diminution in

value, and made sure that Als actively monitored and managed those exposures, including marking to market appropriately. Furthermore, complaints triggered by losses on stock accumulators due to the stock market correction rose considerably in 2008 and the HKMA allocated more resources to conduct investigatory reviews on these complaints. As a result of the extra workload arising from these unexpected events, the number of regular and securities (tier-2)¹ on-site examinations conducted in 2008 was lower than that in 2007.

Out of the 161 on-site examinations, about one-third (50) were thematic examinations, including reviewing compliance in the use of credit facilities for intended purposes; compliance with the restrictions on renminbi business; controls over regulated activities including compliance and selling practice; controls over Als' investment in structured financial instruments; system capacity and contingency planning for on-line securities trading service systems; operational risk management; and anti-money-laundering (AML) and counter-terrorist-financing (CFT) controls over trade financing activities.

The HKMA conducted 53 risk-based and four overseas examinations. Specialist teams also carried out detailed examinations of risk management controls in specific areas, including Als' treasury and derivatives activities, interest rate risk management, commercial and consumer lending, business continuity planning, e-banking activities and technology risk management and practice, and the selling of accumulators; and tier-2 examinations of the securities business of Als and their AML/CFT controls.

Specialised reviews were also performed on the qualitative and quantitative aspects of internal rating systems, and the relevant IT supporting systems to assess the readiness of Als intending to implement either the foundation or advanced internal ratings-based (IRB) approach for credit risk under Basel II in 2009 (*see section on Basel II implementation for details*).

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

Banking Stability

In addition to on-site examinations, 188 off-site reviews were conducted and 39 tripartite meetings² held. Other duties included the approval of acquisitions of local AIs and the handling of non-compliance with guidelines or statutory requirements. The supervisory teams met the boards of two banks and members of board-level committees.

The Banking Supervision Review Committee considered 22 cases in 2008, with six relating to the licensing of AIs and approval of money brokers and the other 16 dealing with the imposition of conditions, revocation, and the exercise of the Monetary Authority's powers under section 52 of the Banking Ordinance. In addition, 301 applications to become controllers, directors, chief executives and alternate chief executives of AIs were approved. Details of the operational supervisory work performed in 2008 are set out in Table 1.

The Monetary Authority used his powers under section 59(2) of the Banking Ordinance to require five AIs to commission external auditors to review internal control issues and to report their findings to the HKMA. Another seven AIs voluntarily appointed external auditors to review their controls on selected areas identified by the HKMA.

In 2008 no AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio (CAR). One foreign bank branch was found to have breached the liquidity ratio requirement for a short period due to technical errors. It did not pose any threat to the safety and soundness of the institution or to the interests of depositors. There were two breaches of the requirements under section 81 relating to large exposures, six under section 83 on connected lending, eight under section 85 on lending to AI's employees, and one under section 87A relating to shareholdings by an AI. These breaches were assessed to be unintentional. They were rectified promptly by the AIs and did not affect the interests of depositors.

Table 1 Operational supervision		
	2008	2007
1 On-site examinations	161	246
Regular examinations	57	95
– risk-based	53	86
– overseas	4	9
Basel II – IRB validation	8	15
– qualitative and quantitative	5	10
– IT aspects	3	5
Specialised examinations	46	30
– treasury and derivatives activities	3	10
– interest rate risk management	2	–
– commercial lending	10	–
– consumer lending	6	–
– securities (tier-2)	1	7
– selling of accumulators	5	–
– business continuity plan	1	5
– e-banking activities and technology risk management	2	5
– AML/CFT controls (tier-2)	16	3
Thematic examinations	50	106
– review compliance in use of credit facilities for intended purposes	8	–
– renminbi banking business	11	22
– QDII scheme	–	7
– controls over regulated activities including compliance function and selling practice	5	29
– controls over AIs' investment in structured financial instruments	8	–
– IT problems and system change management	–	13
– system capacity and contingency planning of AIs' on-line securities trading service systems	11	–
– operational risk management	4	11
– AML/CFT trade financing activities	3	–
– AML/CFT customer due diligence	–	8
– AML/CFT ongoing transaction monitoring	–	6
– AML/CFT implementation of FATF special recommendation VII in remittance transactions	–	10
2 Off-site reviews and prudential interviews	188	193
3 Tripartite meetings	39	39
4 Meetings with boards of directors or board-level committees of AIs	2	18
5 Approval of applications to become controllers, directors, chief executives, alternate chief executives of AIs	301	296
6 Reports commissioned under section 59(2) of the Banking Ordinance	5	3
7 Cases considered by the Banking Supervision Review Committee	22	12
8 AIs that were subject to the exercise of powers under section 52 of the Banking Ordinance during the year	5	2

² An annual meeting between the HKMA, the AI and its auditors.

Powers under section 52 of the Banking Ordinance

Pursuant to section 53F of the Banking Ordinance, the Monetary Authority revoked the appointment of Mr Paul Jeremy Brough of KPMG as the Manager of Delta Asia Credit Limited (DAC) on 24 October 2008. On the same date, the Monetary Authority proposed the revocation of DAC's authorization as a deposit-taking company under the Banking Ordinance as he was satisfied that certain grounds for revocation as set out in the Eighth Schedule to the Banking Ordinance had been met. The revocation came into effect on 9 December 2008.

The appointment of an Advisor, on 16 February 2007, under section 52(1)(B) of the Banking Ordinance to advise the management of Octopus Cards Limited (OCL), a deposit-taking company, on matters relating to the protection of Octopus cardholders' interests remained in effect during 2008. The Advisor was actively involved in advising, and reviewing the progress of OCL in carrying out the remedial measures recommended in the independent auditors' report on OCL's operational risk control. He also oversaw the refund of money deducted for the failed Octopus EPS add-value transactions from the bank accounts of the affected Octopus cardholders.

Following the publication of a decision taken by the Council of the European Union to introduce financial sanctions against Melli Bank Plc and its parent bank in Iran, the Monetary Authority exercised his powers under section 52(1)(A) of the Banking Ordinance to impose restrictions on the affairs, business and property of the Hong Kong Branch of Melli Bank Plc on 25 June 2008 to protect its depositors.

In addition, the Monetary Authority exercised the powers under section 52(1)(C) of the Banking Ordinance to appoint a Manager to manage the affairs, business and property of Indover Asia Limited³ (IAL), a restricted licence bank, on 13 November 2008, after its parent bank in Amsterdam went into administratorship on 6 October 2008. IAL's parent bank was subsequently declared bankrupt on 1 December by the District Court of Amsterdam and IAL's authorization as a restricted licence bank was revoked on 18 February 2009.

In the second half of 2008, the Monetary Authority exercised his powers under section 52(1)(A) of the Banking Ordinance to issue directions to restrict the business of a deposit-taking company (DTC) in the light of serious deficiencies in the controls and management of the institution. The HKMA also assigned an on-site examination team to monitor closely the AI's compliance with the directions. The DTC's authorization was subsequently revoked by the HKMA and none of its depositors suffered any losses.

CAMEL rating review

The CAMEL Approval Committee met nine times to determine the capital adequacy, asset quality, management, earnings and liquidity (CAMEL) ratings of individual AIs. The institutions were notified of the ratings and were given the opportunity to request a review, although none did so in 2008.

The CAMEL ratings of licensed banks on 20 October 2008 were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board for the purpose of determining the contributions to be paid by banks in 2009 under the Deposit Protection Scheme.

³ Previously known as Indover bank (Asia) Limited

Banking Stability

Specialised supervisory work

Supervision of technology and operational risks

Internet banking, technology risk management and BCP

The utilisation of Internet banking services continued to grow in 2008. By the end of the year, Hong Kong had 5.7 million personal Internet banking accounts, 16% higher than a year earlier, and 401,000 business or corporate Internet banking accounts, up 31%. So far, 37 AIs have implemented a two-factor authentication mechanism for personal Internet banking and some 2.5 million account holders have registered for the service. In November the HKMA worked with the Hong Kong Police Force, the Hong Kong Association of Banks, the Office of the Government Chief Information Officer and the Hong Kong Computer Emergency Response Team Co-ordination Centre to organise a "Clean PC Day 2008" campaign to promote public awareness of Internet banking security.

In early 2008 there were a number of reported incidents involving the loss of personal data by several organisations. As a result, the HKMA issued a circular on 10 July to remind AIs of the importance of measures to protect customer data. In particular, AIs are required to designate an officer of sufficiently senior rank to oversee the handling of loss or leakage of customer data. AIs are also required to regularly review their control measures for reporting data leakage and emerging data security threats.

Following the issuance of a circular on supervisory measures for on-line securities trading systems in 2007, the HKMA completed a round of thematic examinations in 2008 of 11 AIs that were active in providing on-line securities trading services. The examinations reviewed the adequacy and effectiveness of the AIs' system capacity for on-line securities trading services and related contingency plans. A circular was issued to AIs on 4 September on good practices identified in the examinations.

The HKMA continued to participate in the International Information Technology Supervisors Conference to share supervisory experience and knowledge with overseas banking supervisors in e-banking, operational and technology risks, emerging fraudulent techniques and the implementation of Basel II.

Operational Risk Management

Following the establishment in 2007 of an operational risk management specialist team, the HKMA strengthened the supervisory framework in this area in 2008. Four examinations of selected AIs were conducted covering their operational risk management and ongoing compliance with the capital requirements for operational risk under the Banking (Capital) Rules. An annual self-assessment exercise on operational risk management was also launched for 23 locally incorporated licensed banks. The results indicated that the framework established by the selected AIs was in line with the supervisory requirements. The information gathered by the HKMA from the exercise was automatically scored in a risk profiling system to facilitate the continuing assessment and monitoring of individual AIs' operational risk profiles.

Supervision of securities and insurance business

In the light of adverse market conditions affecting the valuations of derivatives instruments, including credit-linked notes and collateralised debt obligations (CDOs), the HKMA recommended that banks distributing such investment products with CDOs as underlying collateral should apply a high risk rating to them by February 2008. Focused on-site examinations were also conducted on four registered institutions (RIs) to examine their dealings and advisory activities for credit-linked investment products.

Following receipt of investor complaints lodged against certain RIs concerning stock accumulators, the HKMA conducted focused on-site examinations of five RIs to ensure their selling activities and complaint handling procedures for stock accumulators and decumulators complied with the legal and regulatory requirements.

The securities-related on-site examinations in 2008 revealed that controls in product due diligence and the selling practices of some of the examined RIs needed to be improved. Those RIs were required to rectify the deficiencies within a reasonable time. Possible mis-selling cases and suspected breaches of regulatory requirements were referred to the HKMA's Securities Enforcement Division for further action.

The HKMA processed seven applications for registration to become RIs and eight applications from RIs to engage in additional regulated activities; and granted consents to 208 executive officers, who are responsible for supervising the regulated activities of RIs, and conducted background checks on 4,814 individuals whose information was submitted by RIs for registration.

The HKMA continued to co-operate with the Securities and Futures Commission (SFC) and the Insurance Authority (IA) on the supervision of Als' securities and insurance-related businesses. Regular contacts were made in 2008 among the HKMA, the SFC and the IA to discuss supervisory issues and enforcement matters through various channels including under the auspices of the Financial Stability Committee and the Council of Financial Regulators.

Supervision of treasury activities

Since mid-2007, the HKMA specialist treasury examination team has given priority and resources to the unfolding US sub-prime mortgage crisis and the global financial crisis, and their combined impact on the banking sector in Hong Kong. As the crisis continued to widen and affect more asset classes and overseas institutions, the HKMA stepped up monitoring of the direct and indirect exposures of Als to these developments, by obtaining regular reports from banks and maintaining close dialogue with their management. On-site visits and stress tests were performed to assess Als' ability to weather additional shocks to such exposures. In November 2008 the HKMA launched two new half-yearly surveys on off-balance sheet exposures and debt securities portfolios to further strengthen the oversight of Als' treasury activities. In the process, the annual survey on credit derivatives and securitisation activities was superseded.

Apart from monitoring the impact of the US sub-prime crisis and the expanding global downturn on banks, the specialist treasury examination team conducted 13 on-site examinations on selected Als' treasury activities during 2008. Of these, eight were thematic examinations focusing on controls on investment in structured financial instruments. The remaining on-site examinations covered mainly Als' control framework for managing interest rate risk and other risks arising from their treasury and derivatives activities.

Banking Stability

China-related businesses

Renminbi banking business

At the end of 2008, 39 licensed banks were conducting renminbi banking business. The total amount of outstanding renminbi deposits reached RMB56.1 billion, representing a 67.9% increase over the previous year. The increase occurred mainly in the first half of the year with the continued rise in the value of the currency. In addition, there was demand for the one-stop service provided by the participating banks to facilitate the opening of renminbi deposit accounts with banks on the Mainland. The HKMA issued a circular to these banks in May reminding them of the compliance issues involved in providing cross-border one-stop renminbi services.

The amount of renminbi bonds issued in Hong Kong also increased substantially during the year as four Mainland banks launched new issues for a total of RMB12 billion. The over-subscription for these issues demonstrated the huge demand for renminbi bonds in the local market.

Tapping the Mainland market

At the end of 2008, 14 locally incorporated banks had business operations in Mainland China, including seven banks which have restructured their Mainland branches into Mainland-incorporated subsidiary banks (two of these banks completed the restructuring in 2008) and one bank which acquired a Mainland bank in 2005. Among the eight Mainland-incorporated subsidiary banks, seven can conduct full-scope renminbi business serving all types of customers on the Mainland (including Mainland residents). The 14 locally incorporated banks maintained over 200 Mainland branches or sub-branches at the end of the year, either directly or through subsidiary banks.

The industry's aggregate on-balance-sheet non-bank China exposures at the end of 2008 amounted to HK\$732.2 billion equivalent, or 6% of total assets. These included exposures of HK\$217.5 billion equivalent booked in the Mainland subsidiaries of Hong Kong banks. The HKMA maintains regular contact with the China Banking Regulatory Commission (CBRC) to improve cross-border supervisory co-operation and co-ordination.

Hong Kong banks' Mainland business is also assisted by the Closer Economic Partnership Arrangement (CEPA). The Fifth Supplement to the arrangement, which was signed on 29 July 2008 and became effective from January 2009, allows Mainland-incorporated banking subsidiaries established by Hong Kong banks to locate and operate their data centres in Hong Kong instead of the Mainland, subject to certain conditions. This helps reduce operating costs through economies of scale as well as mitigating operational and IT risks arising from split operations. The HKMA is establishing specific arrangements with the CBRC, including a framework for supervisory co-operation, to ensure the relevant data centres located in Hong Kong are adequately supervised.

Credit risk management and asset quality

In early 2008 the HKMA noticed a growing trend among Als to provide residential mortgage loans (RMLs) to customers with a principal repayment holiday of two to three years. It was concerned that such a practice would expose Als to considerably higher risk and issued a circular in March requiring Als to stop the practice for new RMLs. During the year, a series of specialised examinations was conducted by the HKMA to assess whether Als maintained effective credit risk management procedures to guard against emerging risks arising from the deteriorating economic conditions. The examinations revealed no material weaknesses in the controls.

Following worsening financial conditions in the second half of the year, the HKMA increased its monitoring of Als' asset quality and conducted regular credit risk stress-testing on their loan portfolios. The Als were also reminded to continue to follow the principles set out in the "Hong Kong Approach to Corporate Difficulties" in dealing with customers experiencing financial problems.

Co-operation with overseas supervisors

The exposure of banks around the world to emerging risks and the increased globalisation of banking activities has heightened the need for supervisors to co-operate with one another, both geographically and functionally. The HKMA has entered into Memorandums of Understanding or other formal arrangements with a number of overseas banking supervisory authorities to improve co-operation and the exchange of information. In 2008 Memorandums of Understanding were signed with the Bank of Mauritius and the State Bank of Vietnam. Meetings were held in Hong Kong and abroad with banking supervisory authorities from Australia, Belgium, Germany, Indonesia, Japan, Macau, the Mainland, Malaysia, the Philippines, Singapore, South Africa, South Korea, Switzerland, Thailand, the UK and the US to discuss issues of common interest. There were also regular exchanges of correspondence and communications with overseas banking supervisory authorities on developments in financial markets and their impact on individual banking institutions.

Response to the global financial crisis

The HKMA started close monitoring of the impact of the US sub-prime mortgage crisis on the Hong Kong banking system in mid-2007. Concerns about the holdings of sub-prime mortgage-related assets by individual financial institutions following the collapse of Lehman Brothers in September 2008 quickly developed into fear, and eroded the trust between financial institutions, which in turn significantly interrupted the operations of the interbank market. The confidence of depositors was undermined and resulted in a run on a local retail bank based on unfounded rumours about its financial condition. Since mid-2007, the HKMA has implemented the following measures:

- increased monitoring of Als' direct and indirect exposures to the problem institutions, including monoline insurers and financial institutions which reported heavy losses due to US sub-prime mortgage-related assets
- performed regular stress tests to assess whether retail banks in Hong Kong had adequate capital to withstand significant losses should financial markets deteriorate further
- required banks to ensure transparency in their disclosure of sub-prime-related exposures and adopt a prudent approach in valuation or making impairment charges for these exposures in their 2007 financial results, although the exposures of the Hong Kong banking sector to sub-prime-related assets are immaterial
- increased monitoring of Als' liquidity position and required individual Als to have their own contingency liquidity plan in place from early 2008 for handling potential and actual liquidity problems

Banking Stability

- stepped up the HKMA's internal readiness for triggering Lender-of-Last-Resort support in case of need, and took measures to ease the liquidity tightness in the Hong Kong interbank market
- established a new arrangement with the People's Bank of China (PBoC) whereby Hong Kong banks operating on the Mainland can obtain collateralised renminbi liquidity from the PBoC, with the collateral provided by the parent or headquarters in Hong Kong to the HKMA for safe keeping on behalf of the PBoC. This arrangement will ease any renminbi liquidity pressure of the Mainland branches and subsidiaries of Hong Kong banks.

In addition, a number of measures were adopted to restore public confidence and ensure the normal operation of the local banking system:

- the Financial Secretary announced the use of the Exchange Fund to guarantee the repayment of customer deposits held in Hong Kong with all Als starting from 14 October 2008 until the end of 2010 following the principles of the existing Deposit Protection Scheme
- a Contingent Bank Capital Facility was established over the same period to provide locally incorporated licensed banks with access to additional capital should this become necessary. The HKMA also adopted a flexible approach towards the buffer above the statutory minimum CAR of 8% imposed on individual local Als to ease the constraints of their capital for continuing the provision of credit
- provision of collateralised lending to individual banks in need of liquidity through or outside the Discount Window was made easier through a number of temporary measures
- issuance of Exchange Fund paper was increased to meet market demand from banks for liquidity management

- the HKMA issued a statutory guideline on 24 October 2008 explaining the approach being adopted in enhancing the monitoring of Als' activities to pre-empt the emergence of any imprudent business practices and prevent any potential moral hazard arising from the introduction of the full deposit guarantee and Contingent Bank Capital Facility
- the frequency of collecting prudential data from Als through ad-hoc surveys was increased to facilitate a closer supervisory surveillance over Als' financial positions and business activities, particularly deposit movements and asset quality
- two new half-yearly surveys on off-balance sheet exposures and debt securities portfolios were introduced to strengthen the HKMA's oversight of Als' holdings of debt securities and their exposures to structured credit products or related off-balance sheet entities which have been affected substantially by the global financial crisis
- monitoring of Als' liquidity positions was increased to ensure they have adequate high-quality assets to exchange for liquidity in emergencies.

The HKMA will continue to work closely with the HKSAR Government, and Mainland and overseas authorities to preserve the stability of the local banking system. The enhanced supervisory efforts will continue for the time being, to ensure that Als can weather the current global crisis.

Lehman-related investment products

On 14 September 2008 Lehman Brothers Holdings Inc. filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code. Subsequently, the HKMA received a large number of complaints from retail investors who purchased from banks structured investment products, including those known as Minibonds, related to Lehman Brothers.

To process these complaints as quickly as possible while ensuring due process, the HKMA deployed about 200 staff (including its own staff and others seconded from external auditing firms) to handle the complaints. The HKMA also agreed with the SFC a set of specifically designed procedures to deal with the large number of complaints.

Under these procedures, the HKMA reviews each complaint to ascertain whether there is prima facie evidence to open an investigation. If an investigation is opened and during the course of the investigation the HKMA finds sufficient justification, it refers the case to the SFC to facilitate its investigation at the institutional level, and to decide whether further action, including the imposition of sanctions, is warranted. (The SFC is the authority ultimately responsible for deciding whether a Registered Institution has been guilty of misconduct.) The HKMA will continue its review of individual cases, whether or not referred to the SFC, to investigate if there has been misconduct by individual staff members of the banks concerned.

In early October the Government proposed that banks involved in the sale of Minibonds should buy them back from the investors at their current market values. The proposal was accepted by the distributing banks and the Hong Kong Association of Banks set up a Task Force to pursue the matter. To ensure that the investors would receive fair treatment under the proposal, the HKMA appointed an independent financial adviser on behalf of the Government to review the valuation and strategy adopted by the Task Force in implementing the proposal. In November the trustee for the Minibonds received a letter from the legal advisers to Lehman Brothers in the US. The letter asserted that, according to the US Bankruptcy Code, the trustee's actions since

14 September 2008 might be invalid, and that the trustee might not lawfully realise the collateral and pay the money to Minibond investors, and should refrain from taking any further action. Having obtained advice from their legal advisers and, after consultation with the Government, the banks decided to continue the buy-back only after the legal issues had been clarified and addressed. The distributing banks have continued to liaise with the trustee regarding the proposed steps to be taken to protect the interests of the investors. On 17 December the distributing banks announced that they were prepared to provide finance to the trustee of up to \$100 million to assist in the performance of its duties to protect the interests of the Minibond investors.

Separately, the HKMA announced on 31 October a mediation and arbitration scheme to help resolve questions of compensation between investors in Lehman-related investment products and the distributing banks. The service is provided by the Hong Kong International Arbitration Centre. The HKMA has agreed to co-ordinate referrals and pay the share of the fee for these services for investors whose complaints have been referred by the HKMA to the SFC, or whose complaints have resulted in a finding against relevant bank staff by either the HKMA or the SFC.

On 12 November the Legislative Council passed a motion to confer powers under the Legislative Council (Powers and Privileges) Ordinance to a Sub-committee to study issues arising from the Lehman Minibonds and related structured financial products. The HKMA has provided the Sub-committee with information and documents to assist in carrying out its review.

On 31 December the HKMA submitted a report to the Financial Secretary to provide observations and information on lessons learned and issues identified during the process of investigating the complaints about the sale of Lehman-related investment products. The report will be used by the Government in undertaking a comprehensive review of the present regulatory framework governing the sale of investment products to retail investors.

Banking Stability

Review of the HKMA's work on banking stability

In late 2007 the HKMA appointed an independent consultant to undertake a review of how the HKMA could best discharge its functions in promoting the general stability and effective working of the banking system, taking into account recent and likely future developments in Hong Kong's banking system and the changing nature of the risks it faced.

The review was completed in July 2008, and the report was subsequently published for public consultation for three months until the end of October. In the report, the consultant acknowledged the robust condition of Hong Kong's banking sector and concluded there were no fundamental deficiencies in the HKMA's regulatory and supervisory framework or processes. Nevertheless, to provide the HKMA with a sounder foundation to cope with the challenges ahead, the report recommended a number of improvements to the present regulatory framework for the banking sector, addressing trends and issues such as business integration with the Mainland, the impact of the US sub-prime crisis on the banking sector, further development of Hong Kong as an international financial centre, increasing competition in the financial markets, and erosion of financial boundaries.

In all, 15 submissions were received during the public consultation period, including responses from the Hong Kong Association of Banks, the DTC Association and the Consumer Council.

Basel II implementation

Monitoring the effectiveness of the revised capital adequacy framework introduced by the Banking (Capital) Rules and Banking (Disclosure) Rules in January 2007 was a subject of special focus by the HKMA in 2008. Particular attention was paid to compliance with the relevant requirements by those Hong Kong-incorporated Als that

have adopted, or have applied for approval to adopt, the internal ratings-based (IRB) approach for regulatory capital reporting purposes. In the light of experience from the implementation of the framework, the HKMA refined its supervisory review process, under which Als' capital adequacy and risks, as well as their progress in developing their own capital adequacy assessment processes, are assessed. The continuing global financial crisis also required the HKMA to consider the implications for Hong Kong of international developments affecting the Basel II framework.

Supervisory recognition and monitoring of Als' adoption of the IRB approach

In 2008 the HKMA granted approval for three Hong Kong-incorporated Als to adopt the foundation or advanced IRB approach to calculate credit risk under the Banking (Capital) Rules from January 2009. The approvals were granted after on-site examinations to assess the robustness of the Als' internal rating systems and their compliance with the requirements set out in the Banking (Capital) Rules for the use of the IRB approach. The HKMA also conducted follow-up reviews of those Als previously approved to use the IRB approach to ascertain that any issues identified in previous on-site examinations had been fully addressed, and to ensure their ongoing compliance with the relevant IRB requirements.

The HKMA developed an internal MIS report to facilitate credit risk analysis and monitoring of the IRB data submitted by Als which had either adopted the IRB approach or applied to adopt the IRB approach and were undergoing the requisite parallel reporting during the year. Analyses across various types of credit risk parameters, exposures, obligors, and peer groups, as well as trend analyses, were conducted regularly to help monitor the level and trend of the credit risk of these Als and the impact of using the IRB approach on their capital levels.

Home/host co-operation

In deciding whether to grant approval for subsidiaries of foreign banking groups to adopt the IRB approach in Hong Kong, the HKMA, as host supervisor, considered the assessments of their home supervisors. In particular, the HKMA relied on the home supervisors' reviews of group-developed internal rating systems proposed to be used by the subsidiaries in Hong Kong. The HKMA participated in supervisory meetings organised by the home supervisors for selected individual banking groups to keep itself informed of the IRB approval and implementation progress of these banking groups, and to discuss other issues of mutual interest.

Supervisory review process (SRP)

The approach developed by the HKMA for conducting the SRP has provided a comprehensive framework for assessing Als' capital levels and risks, including various non-credit risks, such as interest rate risk in the banking book, liquidity risk, and reputation and strategic risks. The SRP was further refined in 2008 in the light of implementation experience and lessons drawn from the global financial crisis. The assessment of some risk factors relating to credit concentration risk, liquidity risk, corporate governance and systems and controls was enhanced.

During the year, the HKMA completed the second round of SRP on Hong Kong-incorporated Als using the refined assessment framework. The SRP Approval Committee within the HKMA met regularly to review the assessment results for Als for the purpose of considering their minimum CARs and other supervisory issues requiring attention. Als were notified of the results, and were given the opportunity to request a review of their minimum CAR, although none did so in 2008.

Capital adequacy assessment process (CAAP)

CAAP is an internal process whereby Als assess whether their overall capital adequacy is commensurate with the risk profile of their operations and formulate a strategy for maintaining adequate capital levels. Following the implementation of the SRP in 2007, Hong Kong-incorporated Als were expected to have a firm plan for adopting a CAAP that meets supervisory standards. The HKMA continued to monitor Als' progress in CAAP development in 2008, reviewing the project plans, status reports, and CAAP policies and methodologies they submitted and meeting with their management to exchange views on the subject. While noticeable progress was made by the Als in developing or updating their CAAP, more time is needed in certain cases to complete the project given the evolving methodologies and techniques and the need to address various issues associated with the development process.

Disclosure

Hong Kong-incorporated Als continued to make financial disclosures in accordance with the enhanced disclosure requirements under the Banking (Disclosure) Rules and the relevant accounting standards (*HKAS 1 Presentation of Financial Statements and HKFRS 7 Financial Instruments: Disclosures*). The HKMA also recommended that they should adopt the Leading-Practice Disclosures for Selected Exposures compiled by the Senior Supervisors Group [see separate box on *Improving the supervisory framework for details*].

Banking Stability

Counterparty credit risk (CCR)⁴

The HKMA conducted a further survey in early 2008 on the CCR management practices of selected AIs, the results of which reinforced the need to develop CCR management guidance (which was released for industry consultation in December 2008), ahead of any plan to implement locally the more advanced CCR calculation methods available under the Basel II framework. The HKMA will review the approach and timetable for implementing these more advanced CCR calculation methods once AIs have had sufficient opportunity to implement the CCR guidance, so that a better picture of their CCR management systems and capabilities can be gathered. This will also enable the HKMA to take account of any CCR-related market developments when it determines the implementation strategy.

Recognition of external credit assessment institutions (ECAIs)

The use of credit ratings assigned by ECAIs recognised by the Monetary Authority is a typical feature of the standardised approach for calculating credit risk under the Banking (Capital) Rules. During the year, the HKMA reviewed applications for recognition of certain domestic ECAIs in India and Japan, based on the eligibility criteria specified by the Monetary Authority and the recognition granted to those institutions by their local supervisory authorities. The Banking (Capital) Rules will be amended to add these institutions to the list of recognised ECAIs under the Rules.

Basel II-related international developments

In addressing issues identified by the global financial crisis, the Basel Committee on Banking Supervision has developed proposals for strengthening the Basel II framework. In January 2009 the Committee released consultative documents on enhancements to the Basel II framework, including enhanced capital and disclosure requirements for structured credit and securitisation activities, supplemental Pillar 2 guidance to address the flaws in risk management practices revealed by the financial crisis, the introduction of an incremental risk charge for trading book positions, and other revisions to the market risk capital framework. The Committee is also considering improvements to other areas of the framework. The HKMA monitored these developments and provided its comments to the Basel Committee where appropriate. Amendments to the Banking (Capital) Rules will be required for the adoption of these measures in Hong Kong.

 Basel II

⁴ Counterparty credit risk (CCR) is the risk that the counterparty to a transaction may default before the final settlement of the transaction's cash flows. However, an economic loss would only occur if the transaction with the counterparty has a positive economic value at the time of default. CCR thus involves a bilateral risk of loss to either counterparty to the transaction, depending on the market value of the transaction which may vary over time with the movement of underlying market factors.

Improving the supervisory framework

Lessons from the global financial crisis

The HKMA has been monitoring closely the international initiatives and developments arising from the US sub-prime crisis. In October 2007 the G7 Finance Ministers asked the Financial Stability Forum (FSF) to analyse the underlying causes of the global financial market turbulence triggered by the sub-prime crisis. The FSF presented its report, *Enhancing Market and Institutional Resilience*, to the G7 Finance Ministers in April 2008, among other international responses to the crisis such as those from the Senior Supervisors Group (SSG)⁵ on improving risk management and disclosures, and the Report of the President's Working Group on Financial Markets.

The FSF's report contains detailed recommendations in five main areas:

- strengthening prudential oversight of capital, liquidity and risk management
- enhancing transparency and valuation
- changes in the role and uses of credit ratings
- strengthening the authorities' responsiveness to risks
- robust arrangements for dealing with stress in the financial system.

The HKMA, as a member of the FSF, strongly supports and participates in the development of the recommendations of the FSF, SSG and other relevant international organisations, and is taking steps to implement the recommendations as appropriate in Hong Kong. As a first step, the HKMA has encouraged AIs to improve their governance and risk management systems, drawing reference to the recommendations of the FSF and the SSG.

The Declaration of the Leaders of the Group of Twenty (G20) in November 2008 is also of relevance. It sets out action required to implement reforms that will strengthen financial markets and regulatory regimes to avoid future crises. The measures falling within the supervisory remit of the HKMA, such as those relating to transparency and accountability, sound regulation, and international co-operation, are similar to the recommendations in the FSF report.

Accounting, disclosure and valuation issues flowing from the financial crisis

Recent market events have demonstrated the importance to market confidence of reliable valuations and relevant disclosure of financial institutions' exposures to, and the risks associated with, sub-prime-related or structured products. The HKMA has encouraged local banks to be prudent in valuing these exposures and to ensure that an adequate impairment charge is made for them. The HKMA met the Hong Kong Institute of Certified Public Accountants (HKICPA), major auditing firms and individual banks in the first quarter of 2008 to promote the adoption of an approach that ensured prudent valuation and transparency of disclosure of the banks' exposures in their 2007 financial results.

In the light of the FSF's recommendations concerning risk disclosure, the HKMA requested all Hong Kong-incorporated AIs in May 2008 to disclose their exposures to structured products in accordance with the *Leading-Practice Disclosures for Selected Exposures* compiled by the SSG. In line with the practices, large local banks have substantially expanded their interim 2008 disclosures for risk exposures (including those associated with complex financial instruments), valuations, off-balance sheet entities and related policies, although their exposures to sub-prime-related credits, structured investment vehicles and collateralised debt obligations were not material relative to their total assets.

⁵ The Senior Supervisors Group (SSG) is made up of seven participating supervisory agencies from France, Germany, Switzerland, the UK and the US.

In October the HKICPA adopted the amendments to IAS 39 for the equivalent Hong Kong Financial Reporting Standards, which permit institutions to reclassify their non-derivative financial assets out of the “held for trading” category to the “available for sale” or “held to maturity” category, in rare circumstances, dating back to their positions at 1 July 2008. Such reclassification was already permitted under US GAAP in rare circumstances. The HKMA has no objection to Hong Kong-incorporated AIs making use of such changes to IAS 39, in view of the unusual circumstances prevailing in the global financial markets. It is estimated that any reclassifications permitted under the revised IAS 39 are unlikely to have any material impact on AIs’ equity or earnings for the second half of 2008.

Implementation of Basel Committee’s revised liquidity guidance

The Basel Committee published the Principles for Sound Liquidity Risk Management and Supervision in September 2008. These Principles, which represent a substantial revision of the Basel Committee’s previous liquidity guidance issued in 2000 and reflect lessons from the global financial crisis, were developed to raise international standards for the management and supervision of banks’ liquidity risk.

In line with its policy of adopting international standards, the HKMA formulated an action plan to improve the supervisory framework for liquidity risk in Hong Kong to align it with the Basel Committee’s revised liquidity guidance, and commenced a review of the existing framework in the fourth quarter of 2008 to identify potential areas for change. The review includes the methodology for the calculation of the statutory minimum liquidity ratio and the individual components included in that calculation.

In addition, the HKMA issued in November 2008 a standardised template to AIs requiring them to conduct a self-assessment of their compliance with the Basel Committee’s revised liquidity guidance. The HKMA will use the results to gain a better understanding of AIs’ current liquidity risk management practices and identify any major compliance gaps or implementation

issues that may warrant more supervisory guidance or attention.

Group-wide approach to supervision of locally incorporated AIs

In view of the growth in financial groups, which include banking operations and their diversification across jurisdictions and financial sectors, as well as the increased emphasis internationally on the importance of consolidated supervision, the HKMA issued a Supervisory Policy Manual (SPM) module on the “Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions” in November 2008 following consultation with the industry. The module was developed to help AIs understand how an AI’s exposure to risks within its corporate group is addressed in the HKMA’s supervisory framework and practices.

Reputation risk management

In December 2008 after industry consultation, the HKMA issued an SPM module on “Reputation Risk Management” to give AIs a better understanding of its supervisory approach to reputation risk and fuller guidance on how such risk can be managed. The module was also designed to draw AIs’ attention to the importance of reputation risk management and to promote a formalised and systematic approach to managing it, including any crisis that might be triggered by events adversely affecting their reputation.

Counterparty credit risk (CCR) management

The global financial crisis has underlined the importance of CCR, as concerns about the difficulties of some major financial institutions or counterparties have thrown markets into disarray. After completing a soft consultation with a selected group of AIs, the HKMA issued a draft SPM module on “Counterparty Credit Risk Management” for industry consultation in December. The module is intended to provide guidance that AIs can adopt in improving or developing their CCR management systems, and to describe the HKMA’s supervisory approach to CCR. The guidance reflects the sound practices for CCR management set out in the Basel II framework, and incorporates, where appropriate, lessons and experiences from the global financial crisis.

Foreign exchange risk management

In December the HKMA also updated and issued for industry consultation the SPM module on “Foreign Exchange Risk Management”, which incorporates the recommendations of the Bank for International Settlements for reducing foreign exchange settlement risk. The revised module was issued on 14 January 2009.

Stress testing

The HKMA conducts regular supervisory stress tests on selected Als to assess the resilience of the banking sector to risks and vulnerabilities within the banking system. Following intensification of the global financial crisis and, in anticipation of the potential effects on the

local economy and Als’ credit quality and profitability, the HKMA increased the scope and severity of its stress-testing scenarios to ensure they remain up to date and appropriate. For example, stress assumptions relating to rates of decline in property and stock prices and the profitability impact on Als were tightened. The results showed that despite the more severe scenarios, the banking sector generally would be able to withstand the stress, although some Als might experience a more significant impact. The HKMA will continue to monitor Als’ capital levels to ensure the adequacy of their capital buffers to withstand a possible worsening of the financial crisis.

Prevention of money laundering and terrorist financing

The main focus for the year was to assist the Government in completing the mutual evaluation of Hong Kong’s regime for combating money laundering and terrorist financing, undertaken jointly by the Financial Action Task Force on Money Laundering (FATF) and the Asia/Pacific Group on Money Laundering (APG).

Following several rounds of discussions with the evaluation team, the mutual evaluation report on Hong Kong was adopted by the FATF at its Plenary Meeting in June and by the APG at its Annual Meeting in July. The report was subsequently published on the websites of the two organisations.

The report recognised the strengths of Hong Kong’s anti-money laundering and counter-terrorist financing regime. It concluded that the AML/CFT supervisory frameworks for the banking, securities and insurance sectors were generally effective, with comprehensive obligations on financial institutions and a fairly broad range of sanctions available to the regulators. The report identified a number of issues for consideration, and the HKMA is reviewing those issues relating to the banking sector.

In March the HKMA, in collaboration with the Industry Working Group on Prevention of Money Laundering and Terrorist Financing, finalised two guidance papers to Als, on “Customer Due Diligence Process for Offshore Companies” and “Address Proof for Personal Customers”. In July the HKMA issued a further guidance paper on “Good Practices on Transaction Monitoring” to provide practical guidance to Als on how to establish an effective monitoring system for identifying suspicious and unusual activities.

During the year, the AML/CFT specialist teams completed 19 examinations, including 16 tier-2 examinations and three thematic examinations focusing on preventive measures in relation to trade finance, an area identified by the FATF as of increasing concern.

International co-operation

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

Banking Stability

Following the implementation of Basel II, the Basel Committee created two new policy sub-groups in 2007: the Capital Sub-group to explore issues surrounding the definition of regulatory capital, with a view to developing an agreed set of capital instruments that are available to absorb unanticipated losses on a going-concern basis, and the Liquidity Sub-group to analyse national liquidity regimes given the changing nature of liquidity risk due to rapid financial market innovation and integration in recent years. The HKMA is a member of both sub-groups. The work of these two sub-groups has grown in significance in view of the global financial crisis. Relating to the work of the Capital Sub-group, the G20 recommended that definitions of capital should be harmonised in order to achieve consistent measures of capital and capital adequacy. This is also in line with the initiatives being taken by the Basel Committee to enhance the quality of tier-1 capital as part of its strategy to address the lessons of the banking crisis. After completing the revision of the Basel Committee's liquidity guidance in September 2008, the Liquidity Sub-group is undertaking further work on formulating analytical frameworks for supervisory evaluation of liquidity risk, as well as providing practical guidance on cross-border and other technical issues associated with implementation of the revised liquidity guidance. The HKMA has participated in the discussions of these sub-groups and offered its views from the Hong Kong perspective.

Islamic banking

With Islamic finance growing rapidly worldwide in recent years, the HKSAR Chief Executive, in his 2007 Policy Address, identified the introduction of Islamic finance to Hong Kong and the development of an Islamic bond market as key government initiatives. In supporting them, the HKMA considered the appropriate supervisory treatment for Als' exposures to Islamic bonds (also known as sukuk). It concluded that the existing legislative framework and approach for the supervision of Als should be suitable for Islamic and conventional banking business.

The HKMA's supervisory policy for holdings of sukuk will reflect the economic substance of these instruments and seek to ensure a level playing field with conventional financial instruments. The supervisory standards to be applied to Als' exposures to sukuk will be the same as those applying to their conventional equivalents. The HKMA's current supervisory approach to Islamic finance in Hong Kong, covering the approval criteria for setting up an Islamic Banking Window⁶ and the supervisory treatment for Als' exposures to sukuk, was set out in detail in an article entitled "Islamic Finance in Hong Kong: Supervisory Issues", published in the December 2008 issue of the *HKMA Quarterly Bulletin*.

During the year, two Malaysian banks commenced Islamic banking business in Hong Kong through Islamic Banking Windows established within their local branches, and a few other Als engaged in structuring or selling Islamic financial products. In considering any proposal to launch Islamic banking business in Hong Kong, the HKMA will take into account a number of factors, including:

- the AI's risk management process to ensure that the risks of the Islamic financial products to be offered are well understood, assessed, monitored and controlled
- the AI's policies, procedures and control systems for ensuring the products are Shariah-compliant
- proper disclosure of risk and return to depositors.

Credit data sharing

The Commercial Credit Reference Agency (CCRA) has been operating smoothly since its establishment in 2004. It initially covered small and medium-sized enterprises (SMEs) defined as non-listed limited companies with an annual turnover not exceeding \$50 million.

⁶ An Islamic Banking Window is a business unit within a conventional AI, enabling the AI to offer Islamic financial services that are consistent with Islamic law on Shariah using the AI's existing infrastructure and branches.

In March 2008 the CCRA coverage was expanded to include sole proprietorships and partnerships. At the end of December, over 120 AIs were sharing commercial credit data through the CCRA, and the scheme contained the credit data of more than 94,000 business enterprises, about 19% of which are sole proprietorships and partnerships. The continued development of the Agency has helped to further strengthen the credit risk management of AIs and improved SMEs' access to credit.

Consumer protection

Code of Banking Practice

The Code of Banking Practice Committee convened by the Hong Kong Association of Banks and on which the HKMA and the DTC Association are represented, completed a comprehensive review of the Code of Banking Practice in 2008. The aim was to improve the Code and to keep it up to date with recent developments in the banking sector. Major improvements include:

- the introduction of a new section requiring AIs to give reasonable notice to customers, normally not less than two months, before closing a branch
- the rewriting of provisions relating to guarantees and third-party securities to make them easier to understand
- the updating of the chapter on "Stored Value Cards (or Devices)" to better protect cardholders, including the introduction of new requirements on card issuers to provide channels to check previous transactions and to reimburse the cardholder, as soon as reasonably practicable, where a transaction cannot be completed successfully but the value has been deducted from the stored value card
- improving provisions relating to security advice for cards and e-banking services to provide more guidance to facilitate compliance by AIs, and to make it easier for customers to understand their obligations in not compromising the security of their card and e-banking transactions.

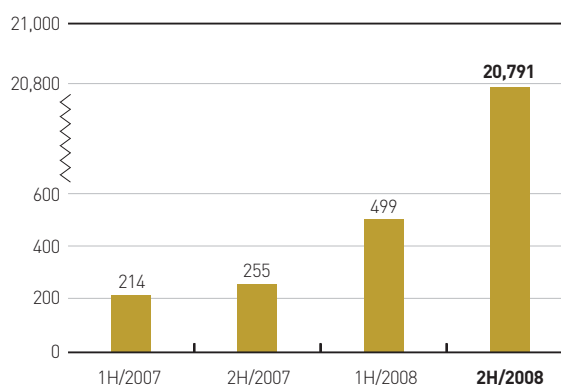
The revised Code became effective on 2 January 2009. AIs are expected to take steps to comply with the revised provisions as quickly as possible and achieve full compliance within six months. A further six-month grace period is allowed for compliance with the revised provisions requiring system changes.

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

Customer complaints

The HKMA received 21,290 complaints about services provided, or products sold, by AIs in 2008, compared with 469 the previous year (Chart 1). The substantial increase was due to the large number of complaints relating to investment products (including those related to Lehman Brothers) sold by AIs (*see separate box on Lehman-related investment products for details*).

Chart 1 Complaints about services or products of AIs received by the HKMA

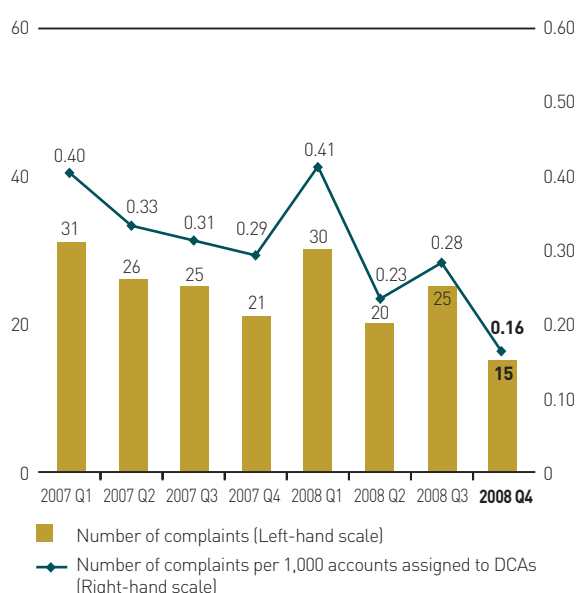


Banking Stability

The number of complaints received by AIs relating to their debt collection agents decreased to 90 in 2008 from 103 in 2007 (Chart 2). The HKMA will continue to monitor the situation to ensure that AIs remain vigilant in overseeing the performance of their debt collection agents.

 > Consumer Information > Complaints about Banks

Chart 2 DCA complaints received by AIs

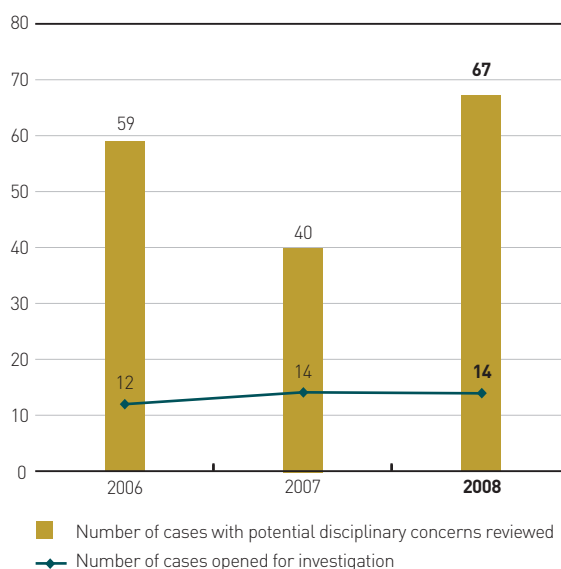


Securities enforcement

The HKMA has a shared responsibility with the SFC for enforcing the rules and regulations on RIs and their executive officers and relevant individuals in the conduct of regulated activities.

During the year, the HKMA reviewed 67 cases (other than those related to the bankruptcy of Lehman Brothers) with potential disciplinary concerns and opened investigations into 14 of them (Chart 3). Investigations of five cases were completed and disciplinary proceedings commenced in one case related to a relevant individual who had facilitated market manipulation. There were insufficient grounds for disciplinary action in the other four cases. The remaining nine investigations are continuing.

Chart 3 Cases with potential disciplinary concerns reviewed by the HKMA



As a result of recommendations made by the HKMA arising from earlier investigations commenced before 2008, the SFC disciplined an RI and two former relevant individuals by exercising its sanctioning power under the Securities and Futures Ordinance, including public reprimand, fine and prohibition order.

Deposit Protection Scheme

The Hong Kong Deposit Protection Board implemented a number of measures to strengthen the operation of the Deposit Protection Scheme. Scheme members were required to submit auditors' reports to certify the accuracy of the returns of relevant deposits submitted by them for contribution assessment purposes. A self-assessment mechanism was implemented to monitor members' compliance with the membership and product representation requirements under the Scheme. Compliance reviews were conducted to ensure that members' systems and data meet the standards specified by the Board and can support a prompt payout. The Board also conducted simulation tests and payout rehearsals, and enhanced the payout procedures and systems to further improve readiness to pay out. The Board's publicity effort helped maintain a high level of public awareness and understanding of the Scheme.

In the light of various international developments on reforming financial regulatory and deposit insurance regimes, and taking into consideration recommendations in the consultancy report on the HKMA's work on banking stability, the Board decided to conduct a review of the Scheme's coverage. The first phase, encompassing the protection limit and membership of the Scheme, commenced in the fourth quarter of 2008.

Following the announcement of the deposit guarantee provided by the Exchange Fund, the HKMA issued a letter to AIs that are not members of the Deposit Protection Scheme requiring them to give representations similar to those required under the Scheme, to inform their customers of the protection available under the guarantee. The representation regime applicable to all AIs was formalised in a statutory guideline issued in early December 2008. The Board also updated its publicity materials to explain the co-existence of the two deposit protection arrangements.

 > Deposit Protection

Licensing

At the end of 2008, Hong Kong had 145 licensed banks, 27 restricted licence banks, 28 deposit-taking companies and 16 approved money brokers. During the year, the HKMA granted two bank licences and one restricted banking licence to three foreign banks, and upgraded two restricted licence banks to licensed banks. The HKMA also granted a certificate of approval to one money broker. One licensed bank, three restricted licence banks and one deposit-taking company revoked their authorization during the year.

PLANS FOR 2009 AND BEYOND

Supervisory focus

Credit risk, capital and liquidity management

The outlook for the global economy remains highly uncertain. The impact of the financial crisis may not have fully surfaced and customers of AIs are likely to face a difficult business environment in 2009 and the challenges for AIs in managing the associated credit risk will be considerably greater. The HKMA will continue to monitor closely the asset quality of individual AIs and assess the adequacy of their systems of internal controls for managing credit risk.

As the financial crisis continues to affect the banking industry, the HKMA will ensure that AIs have effective capital and liquidity management processes that are capable of withstanding severe market volatility.

China-related business

The HKMA will further improve its supervisory policies and practices in line with AIs' continuing business integration with the Mainland. In particular, the HKMA will seek to strengthen communication and co-operation with the Mainland regulatory authorities to ensure new risks arising from this development are well managed.

The HKMA will liaise with the CBRC to establish the framework to improve supervision of data centres following the signing of the Fifth Supplement to CEPA in 2008.

Banking Stability

Supervision of technology and operational risks

Internet banking, technology risk management and BCP

In view of reported incidents of loss or leakage of personal data, the HKMA plans to conduct a round of thematic examinations to cover Als' controls over customer data protection. Separately, a specialist review on the migration of the Real Time Gross Settlement and Central Moneymarkets Unit systems to the SWIFTNet infrastructure will be performed to ensure that the migration is done in a controlled manner and sufficient testing is conducted prior to the migration. To promote sound control practices and awareness of emerging fraudulent techniques, the HKMA also plans to work with the Hong Kong Association of Banks and the Hong Kong Police Force to develop an effective customer education programme.

The HKMA will share its experience in the supervision of Internet banking, technology risk management and business continuity management with overseas banking supervisors through the International IT Supervisors Group, which comprises some 20 banking supervisors from developed markets.

Operational risk management

The operational risk management specialist team will continue to identify and address emerging operational risks of Als through on-site examinations and off-site reviews. The existing self-assessment on operational risk management will be extended to cover certain locally incorporated restricted licence banks and deposit-taking companies in addition to locally incorporated licensed banks.

Supervision of securities and insurance businesses

In addition to conducting regular examinations of Als' securities, insurance and MPF activities to ensure the effectiveness of their compliance with relevant codes of conduct and regulatory requirements, the HKMA will work closely with the Government and the SFC to implement in phases a series of recommendations made in the HKMA's report on the Lehman Brothers incident. These recommendations include improvements to the regulation of the sale of investment products, enhancement to investor protection and review of the current regulatory framework, particularly with regard to the securities business conducted by Als. The HKMA will review the supervisory approach, seek industry views on some of the longer-term recommendations, and monitor Als' implementation of those recommendations that have already been introduced. In addition, the HKMA plans to allocate additional resources and step up the supervision of Als' securities and insurance businesses, including the off-site surveillance work and on-site examinations of these activities.

Supervision of treasury activities

As part of its efforts to reinforce the oversight of Als' treasury activities, the HKMA will strengthen the resources and expertise of its specialist treasury teams in 2009 by recruiting professionals with relevant knowledge and establishing a specialised division to supervise Als' treasury and derivatives activities. The new division will also monitor market trends and developments, and identify emerging market risks so that prompt supervisory action can be taken.

Supervisory policy initiatives relating to the global financial crisis

The HKMA's major supervisory policy initiatives in 2009 and beyond will be driven, to a large extent, by international responses to the current global financial crisis by the Financial Stability Forum (FSF), the Senior Supervisors Group (SSG) and other international organisations to improve the resilience of financial markets and institutions. While the financial crisis has not posed any systemic risk to the Hong Kong banking sector, there is no room for complacency. The HKMA will seek to follow international best practices that contribute to the resilience of the Hong Kong system. In particular, the HKMA will aim to implement the recommendations of the FSF, SSG and other international organisations, having regard to the guidance of the Basel Committee and local circumstances by:

- strengthening the capital adequacy framework through amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules and further refinement of the supervisory review process
- revising the supervisory framework for liquidity risk in line with the *Principles for Sound Liquidity Risk Management and Supervision* issued by the Basel Committee in September 2008
- improving risk management guidance to Als in areas including the management of credit, market, liquidity and counterparty credit risks; stress-testing for risk management and capital planning; management of the risks associated with securitisation and off-balance sheet exposures; management of firm-wide risks, including concentration risks; and governance and controls over valuation processes
- continuing participation in the Basel Committee's review of sound provisioning practices, including the impact of IAS 39 on the levels of provisions maintained by Als, and monitoring of the work of the FSF in examining pro-cyclicality related to loan loss provisions, and considering their implications for the HKMA's supervisory policy

- reviewing the need to issue further guidance to enhance risk disclosure in light of the recommendations of the Basel Committee and the International Accounting Standards Board (IASB), as well as emerging disclosure practices in the industry and in other jurisdictions
- monitoring international developments in the regulation of ECAs and the reforms of their rating processes, and considering amendments to the supervisory policy framework where necessary.

It is expected that these and other issues arising from the financial crisis will dominate the HKMA's policy agenda in the foreseeable future. Many of the issues are complex and the development of international standards is still in progress. The guidance issued by international organisations so far consists largely of high-level principles that will require significant further development before implementation. They will also need to be adapted to local circumstances. The guidance may be subject to change as the global financial crisis continues to evolve. The HKMA will remain vigilant to international developments in banking supervision, and will consider implementing the relevant international standards and practices after taking into account the circumstances of the local banking sector.

Lehman-related investment products

The HKMA is engaging additional contract staff to assist in the investigations of the complaints relating to the sale of Lehman-related investment products. This will enable existing staff, who have been deployed to handle the complaints, to return to their normal duties. The HKMA will also assist the Government in reviewing the present regulatory framework governing the sale of investment products to retail investors.

Review of the HKMA's work on banking stability

The HKMA is studying the comments received during public consultation on the consultant's report, and hopes to develop a policy response in the first half of 2009.

Banking Stability

Basel II implementation

Supervisory recognition for use of the IRB approach

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

The HKMA will also conduct follow-up reviews of the Als previously approved to ensure that they have properly implemented recommendations made by the HKMA previously, and that changes or refinements made to their internal rating systems are appropriate.

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

The HKMA plans to incorporate the Basel Committee's proposals on enhancements to the Basel II framework relating to capital treatment for market risk and securitisation exposures by 2010 by amending the Banking (Capital) Rules and related supervisory guidance. The HKMA will also consider changes to the Banking (Disclosure) Rules, taking into account the proposal issued by the Basel Committee for strengthening disclosure requirements for securitisation and re-securitisation activities, as well as any enhanced disclosure standards proposed by the IASB for complex financial instruments and off-balance sheet entities. Minor refinements to the current Rules may also be necessary in the light of implementation experience since 2007.

Supervisory review process (SRP)

The HKMA will continue to identify areas where the SRP framework can be further improved in view of relevant guidance (including associated stress-testing requirements) issued by the Basel Committee. Als' progress in developing their capital adequacy assessment process (CAAP) will also be closely monitored. In addition to reviewing their policies and methodologies, the HKMA will evaluate the effectiveness of their CAAP and how it is integrated into Als' daily risk management process. Where necessary, more guidance will be provided to assist individual Als in upgrading their existing systems to implement the CAAP standards.

Revision of liquidity supervisory framework

The HKMA will consider necessary changes to make the existing framework more effective, taking into account the approaches adopted by other overseas supervisors in implementing the Basel Committee's revised liquidity guidance, the specific circumstances of the Hong Kong banking sector, and the impact of any proposed changes on individual Als. The HKMA will consult the banking industry once firm proposals are drawn up.

The HKMA will ensure that Als have appropriate liquidity contingency measures to cope with potential market distress; and will continue its monitoring of Als' liquidity risk management and funding positions and require prompt action to address any major deficiencies.

Prevention of money laundering and terrorist financing

In 2009 the HKMA will undertake further institution-specific and thematic examinations to ensure Als remain vigilant against money laundering and terrorist financing, and commence an exercise to consolidate, and where necessary improve, its existing AML/CFT guidelines. This will include issues identified by the FATF and the Asia/Pacific Group on Money Laundering in their joint mutual evaluation of Hong Kong.

In April 2008 the Government established a Central Co-ordinating Committee on Anti-money Laundering and Counter Financing of Terrorism. Chaired by the Financial Secretary, the Committee will steer and co-ordinate the strategic development of Hong Kong's AML/CFT regime in line with internationally recognised standards. A major task for the HKMA in the coming years will be to assist the Committee in formulating appropriate and effective policy measures for the banking sector.

Accounting and disclosure

In addition to the work of the Basel Committee in developing guidance to banks and banking supervisors to strengthen fair valuation processes for financial instruments and risk disclosures under Basel II, steps have also been taken by the accounting standard setting bodies to address the various financial reporting issues highlighted by the global financial crisis. Work underway at the IASB includes improving guidance on valuing financial instruments when markets are no longer active, and the revision of the accounting standard for consolidation of off-balance sheet entities and related risk disclosures. The HKMA will monitor these developments and assess the implications for its supervisory policy framework.

Credit data sharing

The HKMA will work with the industry to promote credit data sharing and believes the continued development of the credit data sharing arrangements in Hong Kong will help to strengthen the credit risk management capacity of Als. This, in turn, will be conducive to maintaining the stability of the financial system.

Consumer protection

The HKMA continues to promote improvements in banking practices through participation in the Code of Banking Practice Committee. It will also monitor Als' compliance with the Code through regular self-assessments and the handling of complaints about services and products provided by Als.

Deposit protection

The HKMA will assist the Hong Kong Deposit Protection Board in operating the Deposit Protection Scheme. While maintaining and improving the efficiency and effectiveness of the Scheme, due consideration will be given by the Board to aligning the Scheme's operation with that of the deposit guarantee provided by the Exchange Fund. The Board expects to complete the review of the protection limit and membership of the Scheme and formulate firm proposals in the first quarter of 2009 for public consultation. Any changes will be confirmed well ahead of the expiry of the guarantee by the end of 2010 to give Als and the public ample time to prepare for the transition. In view of the heightened public awareness of the protection status of their deposits, the Board will increase its promotional and educational efforts to enhance public understanding of the deposit protection arrangements in force. The Board will also join with the HKMA in monitoring whether proper representations are being made by Als of protection under the Scheme and the guarantee.

Market Infrastructure

To promote Hong Kong as an international financial centre, the operating hours of the RTGS systems and the CMU were extended to meet market demand; the HKMA and Bank Indonesia agreed to establish a payment-versus-payment link between Hong Kong's US dollar and Indonesia's Rupiah RTGS systems; and steps were taken to promote Islamic finance in Hong Kong.

OBJECTIVES

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

REVIEW OF 2008

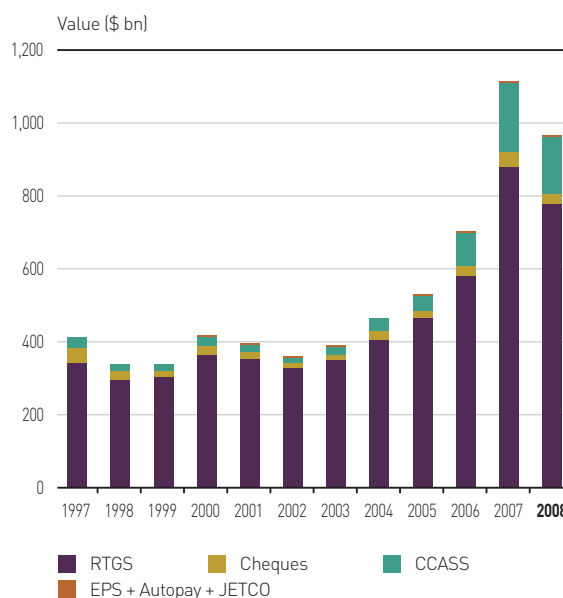
Hong Kong dollar interbank payment system

The Hong Kong dollar Clearing House Automated Transfer System (CHATS), which operates on a Real Time Gross Settlement (RTGS) basis, is responsible for clearing all Hong Kong dollar interbank payments. It has a direct link with the Central Moneymarkets Unit (CMU), which is the debt securities clearing and settlement system operated by the HKMA, to provide both real-time and end-of-day delivery-versus-payment (DvP) settlement services. Hong Kong Interbank Clearing Limited (HKICL), the system operator of CHATS, was established in 1995 and is owned equally by the HKMA and the Hong Kong Association of Banks. In 2008 HKICL processed a daily average of \$777 billion in CHATS transactions (22,633 items).

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

The banks continued to make good use of their Exchange Fund Bills and Notes (EFBN) to obtain interest-free intraday liquidity through intraday repurchase agreements with the HKMA to settle their interbank payments. On average, intraday repurchase transactions totalling \$49 billion were carried out each day, representing 44% of the \$111 billion in Exchange Fund paper held by banks in December 2008.

Chart 1 Hong Kong dollar payment system daily average turnover

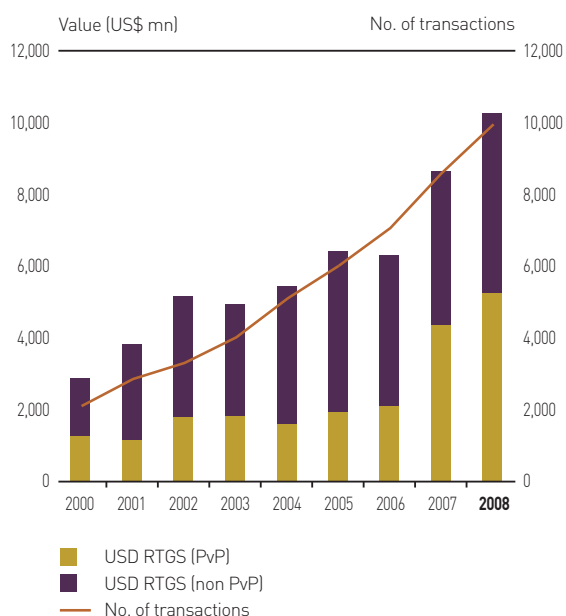


Market Infrastructure

US dollar RTGS system

The US dollar RTGS system has been operating efficiently since its launch in 2000. The Hongkong and Shanghai Banking Corporation is the settlement institution with HKICL as system operator. At the end of 2008, the system had 76 direct and 150 indirect participants, including 123 indirect participants from outside Hong Kong. On average, it handled more than 9,900 transactions amounting to US\$10 billion a day in 2008 (Chart 2). The system also processed a daily average of 7,570 US dollar cheques with a value of US\$234 million.

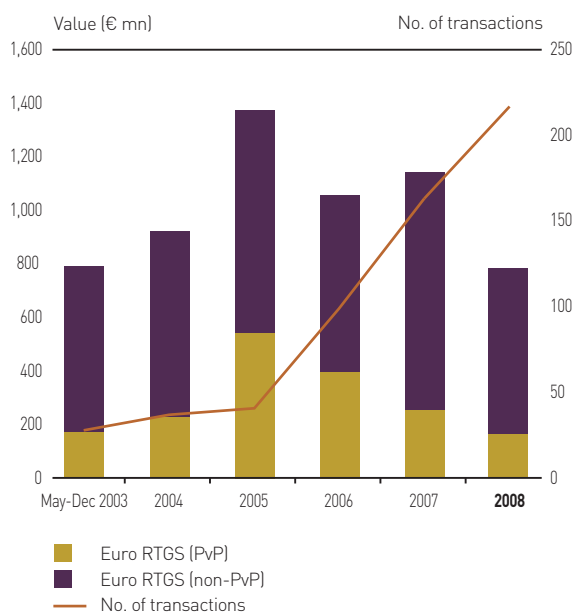
Chart 2 US dollar clearing system daily average turnover



Euro RTGS system

The euro RTGS system was launched in 2003 and has as its settlement institution the Standard Chartered Bank (Hong Kong) Limited with HKICL as system operator. At the end of 2008, there were 30 direct and 20 indirect participants, including 11 indirect participants from outside Hong Kong. In 2008 the system handled on average 217 transactions with a total value of €780 million a day (Chart 3).

Chart 3 Euro clearing system daily average turnover



Renminbi RTGS system

The Renminbi RTGS system, which was upgraded from the Renminbi Settlement System, was launched in 2007. The clearing bank is the Bank of China (Hong Kong) Limited with HKICL as system operator. At the end of 2008, there were 41 direct participants. On average, it handled 1,270 transactions with a total value of RMB610 million a day in 2008 [Chart 4].

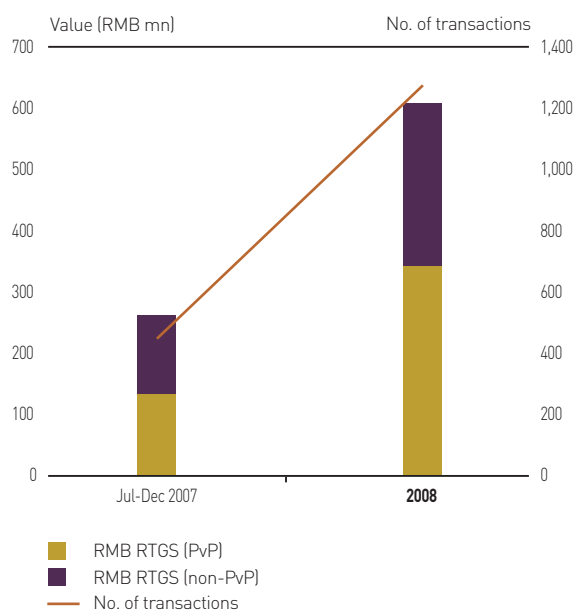
Payment-versus-Payment (PvP)

PvP is a mechanism for settling a foreign exchange transaction to ensure that payments in the two currencies involved are settled simultaneously. The Hong Kong dollar, US dollar and euro clearing systems in Hong Kong

are interlinked to enable banks to settle US dollar/Hong Kong dollar, euro/US dollar, and euro/Hong Kong dollar foreign exchange transactions on a PvP basis. PvP greatly improves settlement efficiency, and eliminates settlement risk arising from time lags in settlements and from time-zone differences (known as Herstatt risk). In 2008 the transaction volume of Hong Kong dollar, US dollar and euro related PvP amounted to \$4,916 billion, US\$1,301 billion and €41 billion.

The Renminbi RTGS system is also linked with the Hong Kong dollar RTGS system to enable banks to square their renminbi positions on a PvP basis. In 2008 the transaction volume of renminbi-related PvP amounted to RMB85 billion.

Chart 4 RMB clearing system daily average turnover



Market Infrastructure

Payment links with the Mainland

In response to the increasing demand for cross-border payment services between Hong Kong and the Mainland, the HKMA has been working closely with Mainland authorities to establish cross-border payment links. The use of these links has risen gradually over the years. In 2008 the average daily turnover of cross-border payments handled by the various system links was over \$1.7 billion [Chart 5].

The RTGS system links with Shenzhen and Guangdong handled more than 26,000 transactions during the year, with a total value equivalent to \$360 billion. The system enables cross-border payments in Hong Kong dollars and US dollars between banks in Hong Kong and their counterparts in Shenzhen and Guangdong to be settled efficiently and safely.

The two-way joint cheque clearing facilities cleared 508,779 Hong Kong dollar and US dollar cheques, with a value equivalent to \$50 billion in 2008. The facilities shortened the clearing time for cheques drawn on banks in Hong Kong and presented in Shenzhen and Guangdong, and vice versa. Since March 2006, the joint cheque-clearing facilities have been expanded to cover renminbi cheques drawn on banks in Hong Kong, and presented in

Shenzhen and Guangdong for consumer spending. In 2008 renminbi cheques with a total value equivalent to \$43 million were cleared.

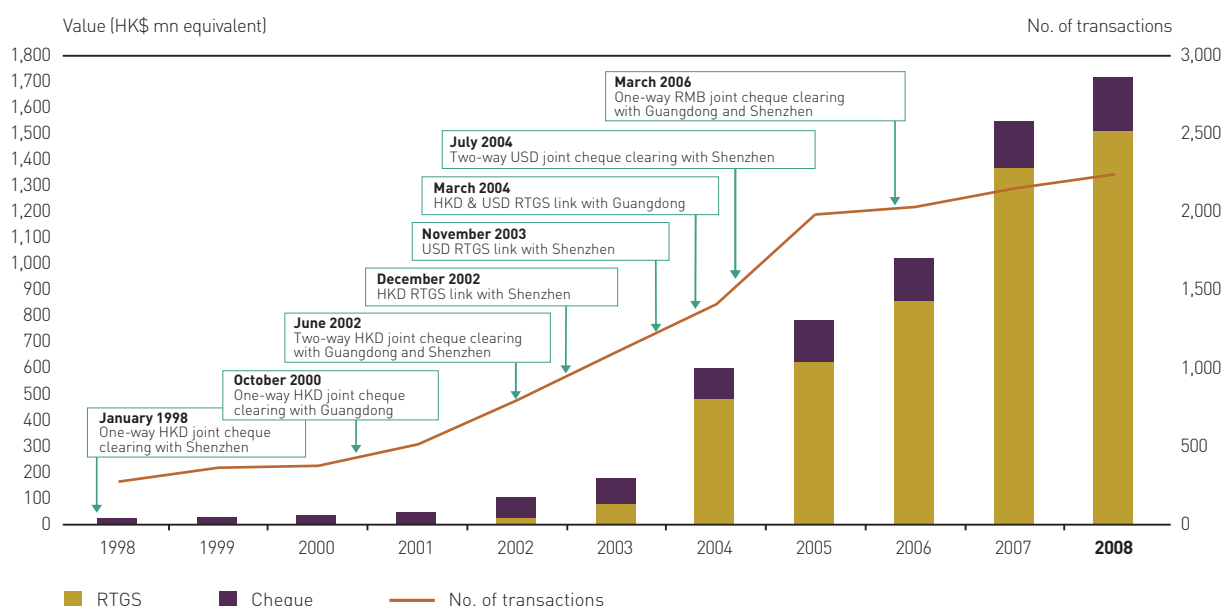
Payment links with Macau

The one-way joint clearing facility for Hong Kong dollar cheques between Hong Kong and Macau was launched in August 2007. The facility, which aims to meet the growing need for efficient payment services between Hong Kong and Macau, has reduced the time required for clearing Hong Kong dollar cheques drawn on banks in Hong Kong and presented in Macau from four or five days to two. In 2008 Hong Kong dollar cheques with a total value of over \$7 billion were cleared.

Debt settlement systems

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

Chart 5 Daily average turnover in cross-border links with the Mainland



In 2008 the CMU processed a daily average value of \$50 billion (136 transactions) in secondary market transactions (Chart 6). Among the debt securities lodged with the CMU at the end of the year, the outstanding amount of EFBN was \$157.7 billion and the total amount of other securities was equivalent to \$234 billion.

Development initiatives in 2008

The HKMA completed a number of systems initiatives and captured new business development opportunities to promote the safety and efficiency of the financial infrastructure, and to develop Hong Kong into a regional payment and settlement hub. In addition, a critical new project was implemented during the year to support the HKMA's introduction of measures to provide liquidity assistance to banks in Hong Kong.

Systems development

The Central Clearing and Settlement System (CCASS) Optimiser was launched in January 2008 to further improve liquidity in the banking system. Through this optimiser, banks which expect to receive funds in the CCASS bulk settlement run can recycle the funds to those in need of liquidity for meeting their payment obligations, thereby improving the recycling of funds and avoiding

any undue impact on money market activities when stock market turnover is high.

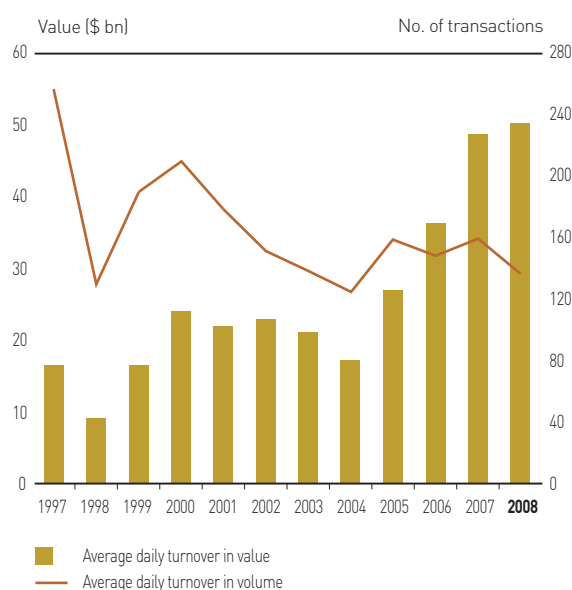
The one-way joint clearing facility for US dollar cheques between Hong Kong and Macau was launched in June, 10 months after the successful launch of the joint clearing facility for Hong Kong dollar cheques. This new cross-border clearing service shortens to just two days, the time required for clearing and settling US dollar cheques drawn on banks in Hong Kong and presented in Macau. Following its inception, 363 US dollar cheques with a total value of US\$10.5 million were cleared up to the end of the year.

System improvements to the CMU were made for the introduction of temporary measures to provide liquidity assistance to banks in Hong Kong in September 2008. As a result, the CMU can now support a wider scope of securities for access to borrowing through the discount window and an extended duration of borrowing from overnight to up to three months.

Initiatives to support the development of Islamic finance in Hong Kong were introduced in September and November. These included activation of a payment code specifically for Islamic-related payment, provision of additional settlement accounts in the US dollar and euro RTGS systems for segregation of Islamic-related funds from other funds, and improvements to the CMU for custodian, clearing and settlement services for Islamic bonds in Hong Kong.

The operating hours of the Hong Kong dollar, US dollar, euro and renminbi RTGS systems, and the CMU were extended from 5:30 p.m. to 6:30 p.m. in November 2008. The initiative helps participating banks to better serve their customers in the region and gives them a longer processing window to manage their liquidity positions.

Chart 6 CMU secondary market turnover



Market Infrastructure

A re-engineered electronic Initial Public Offering (e-IPO) refund process was launched in December as part of the recommendations of the Review of Retail Payment Systems in Hong Kong to shorten the settlement cycle for credit transfer items. It allows e-IPO subscribers to receive their refunds on the refund day instead of the following day; shortens the turnaround time of the e-IPO monies; and further increases the attractiveness of using the e-IPO channel compared with conventional subscription. Implementation of other recommendations of the Review is in progress.

The SWIFTNet migration project, which replaces the existing proprietary platform of the various RTGS systems and the CMU with an open platform, is progressing and will be delivered in two phases in May 2009 and July 2010. SWIFTNet will improve compatibility with other clearing and settlement systems and make it easier for overseas banks to use Hong Kong's RTGS systems.

Business development

Continued efforts were made to pursue two areas of business development — exploring opportunities to link Hong Kong's clearing and settlement systems with those of other Asian economies, and promoting the use of Hong Kong's payment services.

Expanding system links

The HKMA and Bank Indonesia signed a Memorandum of Understanding in October 2008 on the establishment of a cross-border PvP link between Hong Kong's US dollar RTGS system and Indonesia's Rupiah RTGS system. The link builds on the success of the existing model of cross-border PvP link between Hong Kong and Malaysia. It promotes safer and more efficient payment flows and eliminates settlement risk arising from the delivery of different currencies in different time zones. The link will go live in early 2010.

The HKMA and the People's Bank of China (PBoC) have agreed to establish cross-border links between Hong Kong's RTGS systems and the Mainland's domestic foreign-currency RTGS systems. The links, scheduled to start operating in March 2009, aim to increase the settlement efficiency of payments in Hong Kong dollars, US dollars, euros and British pounds between Hong Kong and most parts of Mainland China. A seminar was held in Hong Kong in November to introduce the cross-border links to all banks in Hong Kong.

Resulting from the review of the role of the CMU in 2007, steps have been taken to explore an expanded role for the CMU in the region, particularly in offering an infrastructural solution to helping the development of the Asian bond market.

Promoting the use of Hong Kong's payment platform

Marketing efforts to increase system usage in the region continued throughout the year. The HKMA held or attended 36 seminars and made over 240 marketing calls to potential users in the Greater China region, South East Asia, the Indian sub-continent, the Middle East and Europe.

One approach was to form strategic partnerships with other institutions, including large regional banks and Invest Hong Kong, to make presentations to overseas financial institutions in seminars, road shows and marketing calls, highlighting the capabilities of Hong Kong's multi-currency, multi-dimensional financial infrastructure and promoting Regional CHATS for cross-border payments. The approach proved effective, as reflected in the increase in the average daily volume and value of the US dollar RTGS system over the previous year. The Regional CHATS service was launched in July 2007 to process cross-border commercial payments through Hong Kong using its RTGS systems during Asian business hours. By the end of December 2008, 34 banks in Hong Kong had registered as service providers for cross-border payment services, covering 2,054 payment beneficiary points in 42 economies.

The HKMA was involved in a number of speaking engagements locally and overseas to promote Hong Kong as a payment and settlement hub. In addition, a series of bilateral meetings was held with existing and potential Regional CHATS service providers and users to identify areas for further service development to coincide with the launch of the SWIFTNet platform in 2009.

Oversight of clearing and settlement systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO), which came into force in November 2004, empowers the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre. The purpose of the CSSO is to promote the general safety and efficiency of the designated systems including the CMU, Hong Kong dollar CHATS, US dollar CHATS, Euro CHATS, Renminbi CHATS, and the Continuous Linked Settlement (CLS) System. Except for the CLS System, the HKMA oversees the designated systems through off-site reviews, continuous monitoring, on-site examinations and meetings with management.

The renminbi CHATS was designated on 11 July 2008 and is subject to oversight by the HKMA under the CSSO because the proper operation of the system is considered material to the functioning of Hong Kong as an international financial centre, and the monetary and financial stability of Hong Kong.

All designated systems were found to be in compliance with the safety and efficiency requirements under the CSSO in 2008.

Co-operative oversight arrangements

Clearing and settlement systems have become increasingly interdependent, leading to the establishment of international co-operative oversight arrangements. The CLS System, a designated system in Hong Kong, is operated by CLS Bank, which is primarily regulated by its home supervisor, the US Federal Reserve. The HKMA participates in the international co-operative oversight of the CLS System with the US Federal Reserve and other central banks. In view of the System's importance in reducing the systemic risk arising from the settlement of foreign exchange trades and the expansion of its business to include settlement of non-PvP transactions, the central banks overseeing CLS, including the HKMA, established a CLS Oversight Committee to further strengthen the co-operative oversight of the system from 25 November 2008. Details of the oversight arrangement are specified in a protocol agreed among the central banks overseeing CLS.

The central banks of the G10 countries agreed that SWIFT, a major global message carrier for payment systems, should be subject to co-operative oversight by central banks, with the National Bank of Belgium being the lead overseer since the carrier is incorporated in Belgium. As the CMU accepts SWIFT messages and all the local designated systems will migrate to the SWIFTNet platform to improve compatibility with other overseas clearing and settlement systems, the HKMA has an interest in the oversight of SWIFT and has participated in discussions with the National Bank of Belgium and other central banks on oversight matters.

In 2008 the HKMA continued with its co-operative effort with other central banks in the oversight of links between payment and settlement systems in Hong Kong and those in other countries. One such example was its co-operation with Bank Negara Malaysia, the Malaysian central bank, in overseeing the US dollar/ringgit PvP link between Hong Kong's US dollar CHATS and Malaysia's clearing and settlement system, RENTAS.

Market Infrastructure

Independent tribunal and committee

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

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

The Committee held two meetings in 2008, reviewing four regular reports and 22 accompanying oversight activities management reports of the designated systems. The Committee concluded that it was not aware of any cases where the HKMA had not duly followed the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities. Under its terms of reference, the Committee submitted its annual report, which is available on the HKMA website, to the Financial Secretary.

Informal oversight of retail payment systems

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

In August 2005 the HKMA endorsed the Code of Practice for Multi-purpose Stored Value Card Operation issued by Octopus Cards Limited (OCL) and is responsible for monitoring OCL's compliance with the Code. In 2008 OCL completed its third annual self-assessment against the Code. In July 2008 as a result of HKMA encouragement to the industry to explore ways to introduce competition in the market, OCL and a licensed bank in Hong Kong jointly launched a co-branded card which includes both credit card and contactless smartcard payment functions. This is the first credit card in Hong Kong to have Octopus functions embedded.

In December 2006 a Code of Practice for Payment Card Scheme Operators was drawn up and issued by eight credit and debit card scheme operators with the support of the HKMA. The Code sets out the principles covering operational reliability, data and network security, and the efficiency and transparency of payment card operations in Hong Kong. The HKMA monitors the payment card scheme operators' compliance with the Code and all operators are required to perform an annual self-assessment of their compliance with the Code and report to the HKMA any incident which may have material and adverse impact on cardholders in Hong Kong. In 2008 the HKMA received and reviewed the first self-assessment for the year 2007 from the eight card scheme operators. All scheme operators reported full compliance with the Code.

 Financial Infrastructure > Oversight

International participation

In addition to the international co-operative oversight arrangements, the HKMA participated in other regional and international forums for payment system overseers to discuss issues of mutual interest, including interdependencies between payment and settlement systems, and international principles and standards for payment and settlement systems. In September 2008 the settlement institutions and the system operators of the local designated systems performed self-assessments of

their respective systems against the findings in the report on The Interdependencies of Payment and Settlement Systems published by the Bank for International Settlements (BIS). The performance of all the local designated systems was generally found to be in line with the report's recommendations. The HKMA also took part in an international foreign exchange survey conducted by the BIS to assess the progress made in reducing foreign exchange settlement risk. Following publication of the report on Progress in Reducing Foreign Exchange Settlement Risk in May 2008, the HKMA continued to encourage the industry to adopt appropriate measures to further reduce settlement risks in line with the report's recommendations.

Debt-market development

In early 2008 the Council of Financial Regulators endorsed the recommendations arising from the second phase of the review on debt-market development conducted by the HKMA. The recommendations cover issues related to the regulatory process, investment benchmarks and

guidelines and tax treatments with the aim of attracting issuers and broadening the investor base. Implementation of these recommendations was followed up by the HKMA and other relevant authorities.

Exchange Fund Bills and Notes programme

An electronic trading platform for EFBNs was launched in December 2007 to enhance the price transparency and streamline the trading process of EFBNs. The EFBN daily turnover that involved the electronic trading platform increased steadily to reach 40% of the market total in December 2008.

Separately, the HKMA continued its efforts to fine-tune the maturity mix of the EFBN portfolio, with increased issuance of five-, 10- and 15-year Exchange Fund Notes. To address the strong demand for short-dated Exchange Fund paper by banks for liquidity management purposes, an additional \$18 billion worth of the three-month Exchange Fund Bills was issued during the year.

 Financial Infrastructure > Debt-market Development

Table 1 Outstanding issues of Exchange Fund Bills and Notes

	2008	2007
	(in millions of Hong Kong dollars)	
Exchange Fund Bills (by original maturity)		
91 days	56,953	38,546
182 days	16,900	16,900
364 days	16,900	16,900
Sub-total	90,753	72,346
Exchange Fund Notes (by remaining tenor)		
1 year or below	13,600	13,800
Over 1 year and up to 3 years	28,400	25,000
Over 3 years and up to 5 years	14,800	14,800
Over 5 years and up to 10 years	8,300	10,100
Over 10 years	1,800	600
Sub-total	66,900	64,300
Total	157,653	136,646

Market Infrastructure

Islamic finance

The HKMA adopted a four-part approach in promoting the development of Islamic finance in Hong Kong:

- **Facilitating infrastructure** development through involvement in the Government's tax review to provide a level playing field for Islamic finance transactions in Hong Kong, by reference to the tax and regulatory regimes in other Islamic finance centres and the advice of Islamic finance experts who are members of the Treasury Markets Association (TMA).
- **Raising Hong Kong's international profile** as an emerging centre for Islamic finance through organising a range of promotional activities and participating in international Islamic finance forums. For example, the HKMA organised a road show to the United Arab Emirates and Jordan, engaging senior officials from financial regulatory bodies and major financial institutions to promote Hong Kong to Islamic investors. The HKMA also signed a Memorandum of Understanding with the Dubai International Financial Centre Authority to foster co-operation in the development of Islamic finance products and financial infrastructure.
- **Encouraging product development** through private sector efforts and liaison with government agencies to help resolve tax and regulatory issues to pave the way for new product launches. A range of Shariah-compliant financial services and products has been introduced in Hong Kong, such as the Islamic equity index featuring Mainland companies listed in Hong Kong, Islamic equity funds, exchangeable sukuk and Islamic banking windows.
- **Raising market awareness** by co-operating with the TMA to provide training for industry players in Hong Kong. The HKMA organised and participated in 12 education seminars and workshops covering a wide range of topics, including Islamic equity funds and indices, exchangeable sukuk, tax and accounting treatment of Islamic finance transactions, and Islamic banking developments.

Financial sector development

To promote the competitiveness of Hong Kong's financial markets, the HKMA contributed to the analysis by the Government of the potential for reinforcing Hong Kong's position as a major asset management centre. Several areas for improvement involving different government agencies and regulatory authorities were identified and endorsed by the Council of Financial Regulators to further promote the development of Hong Kong's asset management business. The HKMA continued to assist the Government in developing related initiatives, such as improvements to tax issues that might erode Hong Kong's competitiveness, and co-operation with other agencies to attract asset management business to Hong Kong.

Treasury Markets Association

To strengthen collaboration between the public and private sectors, the HKMA continued to work closely with the market and provide strategic support to the Treasury Markets Association, whose mission is to further promote the professionalism and competitiveness of Hong Kong's treasury markets. The Association, currently chaired by the HKMA's Deputy Chief Executive, Mr Eddie Yue, achieved encouraging results in 2008:

- Membership now stands at some 2,000 individual and 86 institutional members from banks, investment houses, insurance companies, money brokers and large corporations.
- The TMA jointly developed and launched, with the Hong Kong Institute of Bankers, the Treasury Markets Certificate Programme in Beijing, aimed at Mainland treasury market practitioners; and the Professional Certificate in Treasury Markets (Derivatives & Structured Products) with the Hong Kong University School of Professional and Continuing Education (HKU SPACE), as part of the professional qualifications for its members. In 2008 more than 250 individuals took professional courses launched by the TMA.
- More than 50 seminars, workshops and talks were organised during the year for both individual members and staff of institutional members to keep them abreast of market trends and developments.

- To help market participants identify the key themes driving the development of Asia's treasury markets amid the current challenges, the TMA and the HKMA jointly organised the Asia Treasury Markets Summit in Hong Kong in July. The Summit was attended by over 130 market professionals and featured a panel of distinguished speakers from the region comprising regulators and bankers. The TMA also co-organised the South Asia Bond Markets Conference in Hong Kong in September with the World Bank, the Asian Development Bank and the Commonwealth Secretariat, where representatives from different countries shared their experience and thoughts regarding bond market development and regional co-operation. As in previous years, representatives of the Association took part in major international forums to maintain close contacts with overseas counterparts throughout the year.
- The TMA, with the support of the HKMA, secured the decision of the ACI — The Financial Markets Association to establish its first regional office, ACI Asia — The Financial Markets Association Limited, in Hong Kong in July, reflecting Hong Kong's position as a key international financial centre.

PLANS FOR 2009 AND BEYOND

In 2009 the HKMA will continue to improve Hong Kong's market infrastructure in support of initiatives to promote the stability and integrity of the monetary and financial system. The scheduled delivery of the SWIFTNet migration project is one of the priorities. Ensuring the safe and efficient operation of the RTGS systems and the CMU continues to be a key role for the HKMA. The HKMA will also review and improve the existing market infrastructure to attract international financial intermediation activities to Hong Kong and further develop Hong Kong into a regional payment and settlement hub. To this end, exploring opportunities for system links with other economies and promoting the regional use of Hong Kong's financial infrastructure will continue to be the core of business development plans.

The HKMA will work with relevant government departments and market participants to further develop the local debt market. The Exchange Fund Bills and Notes programme will be under constant review as part of efforts to ensure the programme keeps pace with market growth. Further measures will be taken in the development of Islamic finance, by collaborating with government agencies and the private sector to facilitate infrastructure building, promote Hong Kong's international profile, encourage product development and broaden market knowledge of Islamic finance.

As the overseer of designated systems under the CSSO, the HKMA will continue to be involved in promoting and ensuring the safety and efficiency of these systems. In particular, it will conduct assessments on the designated systems against the BIS Core Principles for Systemically Important Payment Systems.

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

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

International Financial Centre

Amid the global financial crisis, the HKMA stepped up regional surveillance and co-operation; participated in international discussions on reform of the global financial system; and strengthened research into and monitoring of developments in Mainland China. In December the State Council agreed to expand the scope of renminbi business, allowing eligible enterprises to use renminbi to settle trade transactions in Hong Kong. Hong Kong's credit rating was raised to AA+ by Standard and Poor's.

OVERVIEW

Global financial markets experienced a challenging year in the face of the global financial crisis. Problems in the financial markets affected the real economy and Asian economies felt the impact of the recession in major industrialised countries. By contrast, despite slower growth, economic and financial developments in Mainland China were more favourable, and inflation, which hit new highs in mid-year on rising energy and food prices, receded as the year progressed.

These developments highlighted the importance of promoting financial stability in the region and in Hong Kong. The HKMA increased its efforts in regional surveillance by co-ordinating the input of surveillance data and preparing macro-monitoring reports for the Monetary and Financial Stability Committee (MFSC) established under the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).¹ The HKMA was involved in meetings and forums of various multilateral organisations in 2008, in particular, the Financial Stability Forum (FSF)², which has come to the fore since the global financial crisis. The HKMA has followed closely the proposals for reforms to the global financial system by the FSF and listed in the Group of Twenty (G20) Action Plan. Research into and monitoring of developments in Mainland China were also strengthened. In financial co-operation initiatives with the Mainland, the HKMA played a key role in the implementation of the Action Agenda on "China's 11th Five-Year Plan and the Development of Hong Kong". Collaboration with Mainland authorities resulted in significant progress, including the additional issuance of more renminbi bonds in Hong Kong; further expansion of renminbi business in

Hong Kong whereby eligible enterprises can use renminbi to settle trade transactions here; and the addition of a new measure for the banking sector under the Closer Economic Partnership Arrangement (CEPA).

REVIEW OF 2008

Regional co-operation and participation in multilateral institutions

The HKMA continued to organise and participate in regional initiatives and discussions on a wide range of issues as part of closer economic and financial integration in Asia. This included hosting a number of international and regional meetings and seminars to bring together monetary and financial experts from many economies.

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

Representing the HKSAR Government, the HKMA took part in negotiations on the Ninth Replenishment of the Asian Development Fund, a concessionary lending facility of the Asian Development Bank for the poorest economies in the region. The Finance Committee of the Legislative Council approved Hong Kong's contribution proposal in early 2009.

Financial market surveillance has become a matter of prime importance since the onset of the global financial crisis. In November members of the G20 set out five principles and an Action Plan that laid the foundation for reforming the international financial system. This is being taken forward by international financial institutions and forums such as the FSF. As an active member of the FSF, the HKMA regularly participates in its meetings to exchange views and information on the latest developments in international financial markets and systems with other member institutions, and is involved in setting and implementing market reform recommendations. In December 2008 the FSF plenary and regional meetings were held in Hong Kong, where members discussed the implementation of the G20 Action Plan. A number of the immediate and medium-term

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

² The FSF was established in April 1999, at the initiative of G7 Finance Ministers and Central Bank Governors, to promote international financial stability. Members of the FSF include national financial authorities from G7, Australia, Hong Kong, the Netherlands, Singapore and Switzerland; the European Central Bank; international financial institutions; international regulatory and supervisory groupings; and committees of central bank experts.

International Financial Centre

actions recommended by the G20 have already been implemented in Hong Kong, and the HKMA will remain involved in the reform of the global financial system.

Promoting monetary and financial stability in Asia

Since the establishment of the Monetary and Financial Stability Committee in 2007, the HKMA has co-ordinated the input of surveillance data and prepared macro-monitoring reports for the twice-yearly EMEAP MFSC Meetings and ad hoc MFSC teleconferences. A joint statement was issued by the MFSC on 30 October 2008 reiterating its commitment to improving co-operation and collaboration. Phase II of the Committee's Chart Pack, a comprehensive set of economic and financial indicators consolidated by the HKMA, was launched to strengthen MFSC's regional surveillance function. The HKMA also developed a multi-region dynamic stochastic general equilibrium model to further enhance the Committee's macro surveillance framework. The model, well received by MFSC members, will be further developed to study policy issues and links among economies in the Asia-Pacific region. The HKMA also contributed to a study of how to improve regional financial arrangements to promote financial stability.

Upgrading Hong Kong's sovereign credit ratings

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

The focus of discussion with CRAs was the structural improvements in the Hong Kong economy 10 years after the Asian financial crisis. It was shown that Hong Kong's robust credit fundamentals, fiscal sustainability, diversified economy, and the diminishing risks emanating from the Mainland all support a higher rating for Hong Kong. Quantitative and comparative analyses placed Hong Kong above the median AAA-economy in credit strength, implying that Hong Kong deserves a higher standalone rating. Comparative studies also demonstrated that Hong Kong had been unfairly penalised by CRAs for political risk.

These efforts contributed to an upgrade of Hong Kong's local- and foreign-currency rating to AA+ by Standard and Poor's, the highest ever assigned to Hong Kong. The upgrade reflected the agency's recognition of Hong Kong's strong economic fundamentals, improved public finances and long-term growth prospects. Other major international CRAs affirmed Hong Kong's AA ratings.

Financial co-operation with the Mainland

Communications and co-operation with the People's Bank of China (PBoC) and other Mainland authorities were stepped up in 2008 with the unfolding of the global financial crisis and heightened volatilities in financial markets worldwide. The improved collaboration resulted in significant achievements on several fronts.

In late December the State Council agreed to a further expansion of renminbi business in Hong Kong, allowing eligible Mainland and Hong Kong enterprises to use renminbi to settle trade transactions on a trial basis. The new business will enlarge the capacity of Hong Kong's financial system to handle renminbi-denominated transactions; improve the city's status as an international financial centre; and expand the renminbi business of Hong Kong banks, opening up new business opportunities. For some traders, using renminbi to settle trade transactions will avoid currency exchange costs relating to settlement in US or Hong Kong dollars. The HKMA is working with the PBoC and other Mainland authorities to implement the related arrangements.

Renminbi business in Hong Kong continued to operate smoothly. At the end of 2008, renminbi deposits totalled RMB56.1 billion and the number of accounts reached 1.2 million. Forty banks in Hong Kong were offering renminbi banking services. The launch of the renminbi bond market in Hong Kong in 2007 created a new channel for financial intermediation between the Mainland and Hong Kong. In 2008 there were four renminbi bond issues, adding to the three the year before, and bringing the total amount of outstanding renminbi bonds in Hong Kong to RMB22 billion.

A new measure for the banking sector was added under the CEPA Supplement V signed in July 2008. The new provision allows the data centres of Mainland-incorporated banking institutions of Hong Kong banks to be located in Hong Kong, subject to the approval and prudential requirements of the Mainland authorities. This will lead to economies of scale in providing information technology support to the banks' businesses in Hong Kong, Mainland China and other areas through their regional data centres. A single-location arrangement may also help reduce operational and technology-related risks. The provision further signifies Mainland authorities' confidence in Hong Kong's legal, regulatory and technical infrastructure for the data centre operations of banks.

Strengthening research on Mainland economic and financial issues

The HKMA continued to undertake research projects to improve understanding of economic and financial developments in Mainland China and their impact on Hong Kong's economy. In 2008 new projects for *China Economic Issues*, a dedicated research series introduced in 2006, included a study of the exchange rate pass-through in Mainland China, the Mainland's monetary regime for dealing with large capital inflows, and co-operation between the bond markets in Hong Kong and on the Mainland. Continuing the international conference series initiated in 2007 dealing with the Mainland's financial sector developments, a conference was held in November 2008 to discuss capital account liberalisation in Mainland China. It attracted a group of experienced researchers and policymakers from central banks, international organisations and research institutes. The conference covered international experiences in capital account opening and reviewed the current stage of capital account liberalisation on the Mainland, including the policy options for further opening up, and the role Hong Kong can play in the process.

 Research > China Economic Issues

Training

Training programmes for officials of the PBoC and the China Bank Regulatory Commission held in Hong Kong and on the Mainland continued to expand. The courses covered monetary policy, financial stability, banking supervision, human resources management, accounting management,

macroeconomic analysis, financial risk management, and prevention of money laundering. In all, 20 courses, or 3,686 man-days of training, were provided to 1,806 Mainland officials. The HKMA also provided training on request to other external parties, including courses for Mainland commercial banks, regulators in the region and a regional course on Risk-focused Supervision and Risk Assessment under the APEC financial regulators' training initiative. Altogether, 255 participants attended the seminars in 2008.

PLANS FOR 2009 AND BEYOND

As the global financial environment is expected to remain volatile in 2009, regional co-operation will be of particular importance in improving financial stability and surveillance. At the request of the Monetary and Financial Stability Committee, the HKMA will arrange workshops to share its multi-region surveillance model with other EMEAP members and organise their efforts for further improvements. The HKMA will also host the annual EMEAP Governors' Meeting in July. Representation in central banking and international financial forums remains a priority, and the HKMA will continue its participation to ensure Hong Kong's views and concerns are heard, including discussions on improving regional financial arrangements. Measures recommended by the FSF and set out in the G20 Action Plan will continue to be actively pursued. At the same time, the HKMA will continue efforts to pursue further upgrades of Hong Kong's credit ratings.

To further improve financial co-operation between Hong Kong and the Mainland, the HKMA will be involved in discussions with Mainland authorities on proposals set out in the Action Agenda. In 2009 a major task is to work closely with Mainland authorities to ensure a timely and smooth implementation of the arrangements for the use of renminbi for settlement of trade transactions. Further improvements will be made to the monitoring of the economic, financial and monetary developments in Mainland China and their implications for Hong Kong. The HKMA will also strengthen co-operation with Mainland regulators, and organise training seminars and courses for staff of Mainland authorities and other external parties.

 Monetary Stability > External Relations

 Press Releases > International Relations

Reserves Management

The Exchange Fund experienced its most difficult investment year since the establishment of the Hong Kong Monetary Authority in 1993. Extreme market volatility and the significant downward adjustment of asset prices had an impact on the Fund, which recorded a negative investment return of 5.6% in 2008.

THE EXCHANGE FUND

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

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives and benchmark

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

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

These objectives take full account of the statutory purposes of the Exchange Fund, and are incorporated into the investment benchmark of the Fund, which guides its long-term strategic asset allocation. Currently the bond-to-equity ratio of the benchmark is 75:25. In terms of currency mix, 86% of the benchmark is allocated to the US dollar and other currencies (which include the Hong Kong dollar) and the remaining 14% to other currencies (which include mainly the euro, yen and sterling).

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

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

The investment process

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

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

Reserves Management

Investment management

Direct Investment

HKMA staff in the Reserves Management Department directly manage the investment of about 80% of the Exchange Fund, which includes the entire Backing Portfolio and part of the Investment Portfolio. This part of the Investment Portfolio is a multi-currency portfolio invested in the major fixed-income markets. The staff also manage positions in financial derivatives to implement investment strategies or control the Fund's risks.

Use of external managers

In addition to managing assets internally, the HKMA employs external fund managers based in over a dozen international financial centres to manage about 20% of the Exchange Fund's assets, including all of its equity portfolios and other specialised assets. The purpose of appointing external managers is to tap the best investment expertise available in the market, capturing a diverse mix of investment styles, and transfer knowledge and information from the market to in-house professionals.

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

Risk management and compliance

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

attribution analyses to make the best use of the investment skills of both internal and external managers.

 Monetary Stability > Exchange Fund

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2008

The world's financial markets experienced a turbulent and perilous year with the financial system coming close to collapse amid reports of huge losses, failing financial institutions and the loss of faith and trust between borrowers and lenders that temporarily paralysed the intermediary function of banks in the last quarter of 2008. The financial crisis began with the weakening US housing market resulting in steep losses for many financial institutions engaged in mortgage lending. This later spilled over to related markets where mortgage debts were restructured into collateral debt obligations (CDOs), with other instruments such as credit default swaps (CDSs) adding complexity. When major financial institutions started to report big losses from their mortgage-related investments, investors and regulators realised that the scope and magnitude of the damage was far beyond their original estimates, and the contagion appeared to be far more extensive than just the US housing market and the financial sector.

Investor confidence was seriously affected by the forced bankruptcy of a number of major financial institutions in the US and Europe, and, perhaps as an unwanted side-effect of the globalisation of financial markets, the contagion spread to almost every part of the globe. Hedge funds and other highly leveraged traders that had invested heavily in CDOs and CDSs were among the worst-hit investor group, suffering large investment losses, client redemption pressure, escalating funding costs and sharply reduced availability of credit.

In an effort to salvage the situation, central banks and authorities in the major economies launched a series of unprecedented measures to support the global financial

system. These included liquidity and capital support to both individual financial and non-financial institutions, as well as guarantees for bank deposits and bank debts. While these measures helped stabilise the financial sector, their effectiveness for the real economy may have been handicapped by the reduced capability of banks to act as financial intermediaries as they strove to shrink their balance sheets and reduce excess lending.

As a result, major economies suffered their first contraction in GDP growth in years as business sentiment and consumer confidence plummeted. Corporate bankruptcy and unemployment rates rose sharply in the second half of 2008, while inflation worries faded as commodity prices dropped significantly on weak demand. Ironically, deflation became the dominating market theme in the second half of the year. The impact of the financial crisis on smaller and developing economies such as Iceland, Korea and Russia was even more severe.

Flight-to-quality trades, risk aversion and balance sheet de-leveraging were the main driving forces in financial markets in 2008, especially in the final quarter. The collective action of investors rushing to off-load risky assets resulted in sharp rate movements and extremely high volatility, increasing the risk of overshooting during the correction process. Major equity markets experienced one of the worst slumps in history with their indices dropping around 30-50% over the year, more than half of which occurred in October. Capital seeking a safe haven flooded the sovereign bond market, which, coupled with the aggressive easing by major central banks, drove government bond yields to historical lows in the fourth quarter. As many investors unwound their previously established carry-trade positions, the sudden increase in demand for US dollars and yen, which were the funding currencies in most of these trades, reversed their weakening trends which had been noticeable since 2001.

The performances of major currency, bond and equity markets in 2008 are shown in Table 1.

Table 1 **2008 market returns**

Currencies

Appreciation (+)/depreciation (-) against US dollar

Euro	-4.9%
Yen	+23.2%

Bond markets

Relevant US Government Bond (1-3 years) Index	+6.8%
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Equity markets

Standard & Poor's 500 Index	-38.5%
Hang Seng Index	-48.3%

The Exchange Fund's performance

The Exchange Fund recorded an investment loss of \$75 billion in 2008, comprising losses of \$77.9 billion and \$73.1 billion from Hong Kong and foreign equities respectively, a \$12.4 billion loss from foreign exchange revaluation, and a valuation gain of \$88.4 billion from bond

investments. The valuation loss, net of dividend income, of the Strategic Portfolio amounted to \$8.9 billion, making a total investment loss of \$83.9 billion. The investment loss after excluding the Strategic Portfolio represented a negative investment return of 5.6%, which was 189 basis points below the return of the investment benchmark for the year.

Reserves Management

Table 2 shows the annualised investment return of the Exchange Fund compared with the investment benchmark and domestic inflation from 1994 to 2008. The annual return of the Exchange Fund from 1994 to 2008 is set out in Chart 1. Since 1994, the Exchange Fund has generated a compounded annual return of 6.1%, which compares

favourably with the compounded annual inflation rate of 1.4% over the period. The comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2008 is shown in Chart 2. Table 3 shows the currency mix of the Fund's assets on 31 December 2008.

[Press Releases > Exchange Fund](#)

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

	Return on total assets	Return on investment benchmark ²	Alpha	CPI(A) ³
2008	-5.6%	-3.7%	-1.9%	+1.2%
2007	11.8%	10.6%	+1.3%	+3.4%
1999 – 2008 annualised	5.5%	4.7%	+0.8%	-0.3%
1994 – 2008 annualised	6.1%	N/A	N/A	+1.4%

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

² Established in January 1999.

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

Chart 1 Investment return of the Exchange Fund (1994-2008)

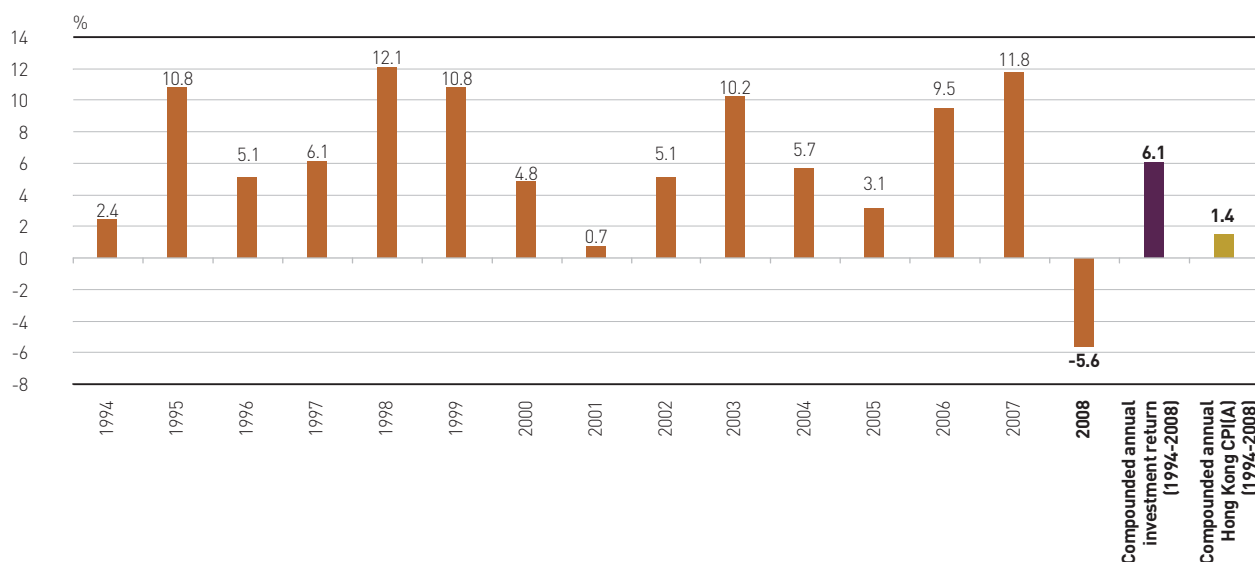


Chart 2 Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2008)

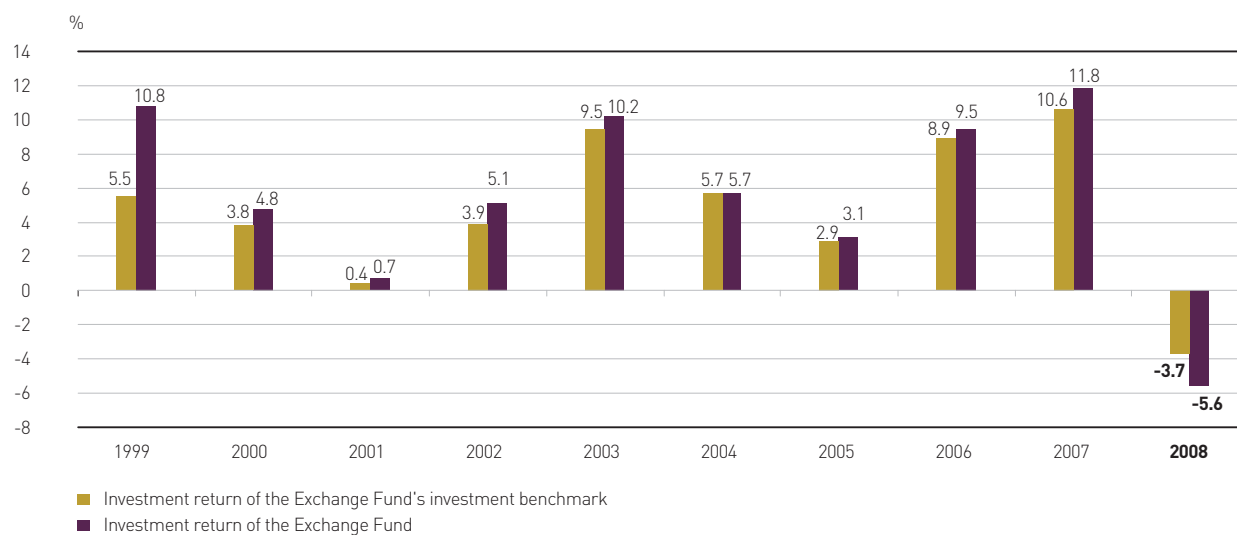


Table 3 Currency mix of the Exchange Fund's assets on 31 December 2008 – including forward transactions

	HK\$ billion	%
US dollar and other currencies ¹	1,245.5	79.8
Hong Kong dollar	99.5	6.4
Euro, yen, sterling and other currencies ²	215.3	13.8
Total	1,560.3	100.0

¹ Including mainly Australian dollar, Canadian dollar and Singapore dollar.

² Including mainly Swiss franc, Swedish krona, Norwegian krone and Danish krone.

Professional and Corporate Services

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

THE HKMA IN THE COMMUNITY

The HKMA strives to be transparent and accessible in its operations. Its work in this area is co-ordinated by the Corporate Development Division within the Corporate Services Department. The Division provides media, publications, public communications and administrative services to the HKMA. It also provides translation and drafting services, and supports the Exchange Fund Advisory Committee (EFAC) and its Sub-Committees.

Media relations

In a year of global financial crisis, maintaining effective and timely communication with the media and the community was even more important than usual. In 2008 the HKMA conducted 41 stand-up media interviews, setting a record and exceeding by three times the figure in 2007. Eight press conferences were organised and 28 media interviews given, in addition to two visits to media organisations. During the year the HKMA issued 271 press releases and handled an average of 50 press enquiries each day. Two media workshops were held: one on the sub-prime crisis and the regulatory response, and the other on the tap issue of Exchange Fund Bills.

 > Press Releases

 > What's New? > Forthcoming Events

Public enquiries

The global financial crisis triggered by the collapse of Lehman Brothers in September 2008 resulted in a large increase in the number of enquiries handled by the HKMA's Public Enquiry Service, with the total jumping by nearly 60% to 10,034 from 6,296 in 2007. Nearly 37% of the enquiries were received in the last quarter of the year as the financial crisis intensified. Banking issues attracted most of the attention in 2008. Chart 1 shows the number of enquiries received each year since 2005 and Chart 2 breaks down the enquiries by type.

Chart 1 Number of public enquiries

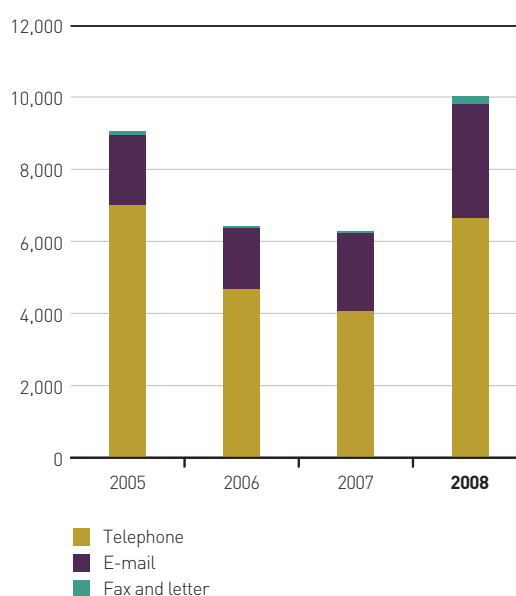
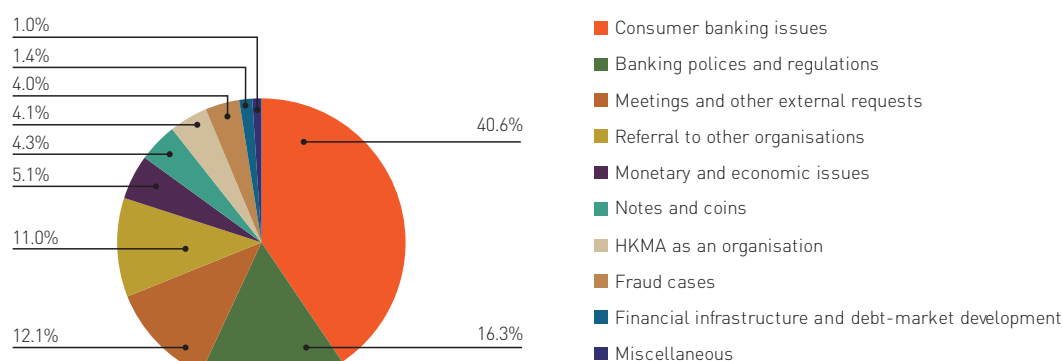


Chart 2 Enquiries received by nature in 2008



Figures do not add up to 100% due to rounding.

Professional and Corporate Services

Publications

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

The *HKMA Annual Report 2007* won a Silver Prize in the Hong Kong Management Association's Best Annual Reports Award. The Report also won a Gold Prize in the 2008 International Annual Report Competition Awards organised by Mercomm, Inc.

 Publications

The HKMA website

The HKMA website www.hkma.gov.hk provides comprehensive and accessible news and information about the HKMA. All the main HKMA publications together with a great deal of other information are available on the website, which contains more than 35,000 web pages.

Public education programme

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

The Centre has displays on the history of money and banking in Hong Kong and the key policy objectives of the HKMA, and provides information on Hong Kong banknotes, Internet banking security and the payment systems of Hong Kong. Guided tours are organised for visitors. During 2008 the Centre received more than 43,000 visitors, and over 500 guided tours were organised for schools and other groups. A quarter of a million people have visited the Centre since it opened in December 2003.

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

The HKMA continued to organise public education seminars on its work. In 2008, three seminars on the Linked Exchange Rate system were organised for more than 3,000 students, teachers and members of the public. Since the launch of the education programme in 1998, more than 39,000 people, mostly students, have participated in HKMA seminars.

 HKMA Information Centre

General administration

The HKMA continued to streamline its work wherever possible to improve efficiency and cost-effectiveness. The inventory checking system was upgraded in 2008 to improve control and efficiency. Business continuity plans are kept under constant review and an evacuation drill is held every year. An internal Event Management Team is responsible for monitoring the changes in the response level of Avian Flu and implementing precautionary or contingency measures as appropriate.

The HKMA's environmental policy is designed to promote staff awareness of environmental protection. Following a decrease of 6.5% in electricity consumption in the HKMA offices¹ in 2007, additional energy saving measures were implemented resulting in a further decrease of 1.4% in 2008. The HKMA also supports and encourages recycling, organising regular campaigns to collect unwanted clothes, toys and other reusable items from staff for donation to charities. Waste paper and used printer cartridges are also collected for recycling.

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

During 2008 teams from the HKMA participated in a number of charity events, winning third place in the Raleigh Wilson Trail Challenge and second place in the Sowers Action Charity Marathon. The HKMA Volunteer Team gave more than 180 hours of their free time to voluntary services in 2008. They participated in a fun day organised by Society of Boys' Centres, visited the New Life Psychiatric Rehabilitation Association and the Holy Carpenter Church District Elderly Community Centre. The HKMA procured office supplies from a workshop operated by people with disabilities.



HKMA volunteers visit the Holy Carpenter Church District Elderly Community Centre.



HKMA's kiosk at the fun day organised by Society of Boys' Centres.

HUMAN RESOURCES

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

Staffing in 2008

The establishment of the HKMA at the beginning of the year was 638. To handle increased workload and improve risk management and support services in connection with the management of the Exchange Fund, 16 new posts were created in June 2008.

The large number of complaints about the sale by banks of investment products related to Lehman Brothers in the last quarter of 2008 required a large-scale mobilisation of resources from late September to early 2009. Nearly a hundred staff were redeployed from both the banking and non-banking departments to the Securities Enforcement Division of the Banking Development Department and a further hundred temporary staff were hired from professional accounting firms to help manage enquiry hotlines and carry out initial fact checking. The deployment of staff for this task diverted resources from the core functions of the HKMA at a time when continuing stress in the financial system required close attention. In order to release redeployed staff to return to core activities, the Financial Secretary, on the advice of EFAC, has given approval for the HKMA to recruit contract staff in 2009 to shoulder part of the extra workload arising from the investigation of the complaints. These staff are recruited on short-term contracts, initially for one year, and their appointment will not affect the permanent establishment of the HKMA.

Professional and Corporate Services

In an increasingly challenging financial environment, the HKMA's workload has increased and become more complex in many areas of its operations. Twenty-two new posts were added to the establishment of the HKMA in January 2009, bringing the establishment to 676 (an increase of 3.4%). These new posts were deployed in the following areas:

- increased surveillance of financial markets
- reviewing the supervisory regime for Als' liquidity-risk management
- formulating policy responses to the recommendations in the Review of the HKMA's Work on Banking Stability
- intensifying supervision following the introduction of the full guarantee of deposits held with all Als in Hong Kong
- helping to ensure that Als' participating in the Government's enhanced Small and Medium Enterprise Loan Guarantee Scheme comply with the terms of the Scheme
- strengthening supervision of local Als' Mainland business
- investigating complaints about banks
- financial-sector development, including the debt-market and fund-management industry and Islamic financial services
- implementing more sophisticated investment approaches, strengthening risk management and compliance in the management of the Exchange Fund, and providing related support services
- strengthening settlement services, computer centre operations, and other support functions.

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

Table 1 gives a breakdown of the establishment and strength of the HKMA.

Table 1 Establishment and strength of the HKMA on 1 January 2009

Department	Functions	Senior staff		Others	
		Establishment	Strength	Establishment	Strength
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	6	6
Banking Development	To formulate policies for the development of the banking industry, and to facilitate settlement for transactions executed by the HKMA for the Exchange Fund.	1	1	125	117
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	34	34
Banking Supervision	To supervise day-to-day operations of authorized institutions.	1	1	111	104
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through active participation in the international central banking and financial community.	1	1	51	47
Financial Infrastructure	To develop and enhance the financial market infrastructure important for maintaining and strengthening Hong Kong as an international financial centre.	1	1	27	23
Monetary Management	To maintain currency stability through monitoring of market operations and development issues, and to ensure adequate supply of banknotes and coins.	1	1	26	25
Research	To conduct research and analysis on economic and international financial market development, both in Hong Kong and in other economies.	1	1	35	34
Reserves Management	To manage reserves to achieve investment returns in line with established guidelines and to enhance the quality of return by diversifying into different investment markets and asset types.	1	1	73	65
Office of the General Counsel	To provide in-house legal support and advice.	1	1	17	15
Corporate Services	To provide support services in the form of administrative, finance, HR, IT, and secretariat services, and to handle media and community relations.	1	1	149	143
Internal Audit	To provide audit services through assisting the management in controlling risks, monitoring compliance, and improving the efficiency of internal control systems and procedures.	0	0	8	8
Total		14	14	662	621

Professional and Corporate Services

Remuneration policies and pay review mechanism

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

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

Remuneration of senior staff

The remuneration packages of the senior staff in 2008 are shown in Table 2.

Table 2 Remuneration packages of the HKMA senior staff in 2008

\$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff	1	3	13
Fixed pay	7,783	4,957	3,203
Variable pay	3,176	1,498	672
Other benefits	974	583	330

Notes :

- 1 Except for annual leave accrued, the actual remuneration received by staff not serving a full year is annualised for the purpose of calculating the average annual package for the rank.
- 2 The number of staff in this table at the Executive Director (ED) rank reflects staff movements during the year and includes the Chief Executive Officer (CEO) of the Hong Kong Mortgage Corporation. The established number of posts at the ED level is 11 (including the CEO of the Hong Kong Mortgage Corporation): please see the organisation chart in this Annual Report for details.
- 3 Other benefits include provident funds or gratuity as the case may be, medical and life insurance and annual leave accrued during the year. The provision of these benefits varies among senior staff depending on individual terms of service.

Training and development

The HKMA makes every effort to recruit high-quality staff through open and competitive recruitment and places special emphasis on training and development. Training is designed to equip staff with the necessary knowledge and skills to fulfil their existing duties and to prepare them for posting and career development. It is provided along two dimensions: horizontal training which focuses on general skills common to staff of the same rank, and vertical training which covers specialised skills specific to individual departments.

One of the highlights of horizontal training is an in-house central banking course, which serves as an induction course for all new recruits at the level of Technical Officer or above, and a refresher course for those who wish to update themselves on specific modules. The course is run in half-day sessions totalling two weeks of training. The course includes an overview of central banking and the financial system of Hong Kong delivered by academics, financial market participants and government officials, and presentations on the roles and functions of the HKMA by internal staff. Less technical courses on individual aspects of central banking functions are organised for support staff. Arrangements are made for staff to participate in central banking courses organised by multilateral organisations or other central banks.

Another focus of horizontal training is on language and management skills. Putonghua and English language drafting courses are organised regularly. Workshops on management topics such as the impact of personality on leadership and management style and courses on presentation skills and strategic thinking were also organised.

In 2008 senior HKMA staff participated in a senior-executive programme in the US, an advanced national studies course in Beijing specially organised for Hong Kong senior government officials, a seminar focusing on global issues, and a number of advanced management workshops run by the Government or by local and overseas universities.

A comprehensive foundation vertical training programme is designed for new Assistant Managers in the banking departments. It comprises a two-week induction course covering topics such as supervisory approach, core principles for effective banking supervision, the Banking Ordinance and regulatory framework, the Deposit Protection Scheme, Basel II, e-banking, and risk management. Classroom training is supplemented by a 30-month on-the-job training programme, during which

the Assistant Managers are rotated among on-site and off-site examination teams under the supervision of a team manager. Throughout the year, training in specific topics is also organised for staff in the banking departments: in 2008 these topics included structured investment vehicles, Islamic finance, sub-prime problems and measures to prevent money laundering.

The number of training days in 2008 declined compared with 2007 because of increases in workload arising from the financial crisis, which had to be given priority. Nevertheless, 2,288 training days were provided (2,667 days in 2007), comprising 1,172 days of training in general skills and 1,116 days of training in job-specific skills, with each staff member receiving an average of 3.72 days of training during the year. The HKMA will seek to restore training to normal levels in 2009.

Apart from formal training, regular staff briefings are conducted by the senior executives on general and topical issues such as financial infrastructure, global inflation, sovereign ratings, monetary development, and the HKMA's role in banking stability.

The HKMA also runs a Training Sponsorship Scheme, which provides sponsorship for the pursuit of degree or diploma studies, professional qualifications or other relevant short courses. Partial reimbursement of membership fees of relevant professional bodies is also provided.

 Careers@HKMA

FINANCE

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

The HKMA draws up its annual budget to ensure that sufficient resources are available for carrying out its functions. Budgeting takes into account both the continuing operations of the HKMA and its strategic development set out in a three-year plan approved by the

Professional and Corporate Services

Financial Secretary on the advice of EFAC. During the budgeting process, departments are required to assess their needs for the coming year and to consider where savings in staffing and expenditure can be achieved. This requires departments to critically assess each year the value of existing services and the cost-effectiveness of different methods of delivering them. The Finance Division scrutinises all budget requests and discusses them with individual departments before submitting a consolidated draft budget for scrutiny by the senior management. The GSC of EFAC then deliberates on the budget and recommends any changes it believes are necessary, before putting it through EFAC to the Financial Secretary for his approval.

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

The administrative expenditure in 2008 and the budgeted expenditure for core activities in 2009 are shown in Table 3. The difference between the 2008 actual expenditure and the 2009 budget arises mainly from an increase in staff costs, reflecting the full-year effects of staff increases and pay adjustments in 2008, and the increase of 22 posts approved for 2009 by the Financial Secretary on the advice of EFAC to meet the increasing quantity and complexity of the work carried out by the HKMA as a result of new and expanded responsibilities, a more risky and challenging financial environment, and new approaches to supervision and investment.

In 2008 unbudgeted expenditures related to the handling of complaints about banking services, mostly for hiring external professional staff, were met from savings in other areas of the HKMA's operations. The continuing commitment to complete the investigation of complaints requires an additional operational expenditure of \$138 million in 2009, mostly for the appointment of contract staff to continue this work and consequential increases in a number of other expenditure items including "premises expenses", "communication services" and "professional and other services". The additional expenditure for this work will be limited to the period necessary for completion of the investigations. Because of the exceptional nature of this work, this additional budget is shown separately in Table 4.

Expenses related to premises for international organisations in Hong Kong are expected to remain stable in 2009. The continued presence of these organisations reflects Hong Kong's status as an international financial centre. Expenditure continued in 2008 in relation to the programme to upgrade Hong Kong's financial infrastructure, including the migration of the Real Time Gross Settlement systems and the Central Moneymarkets Unit (CMU) from the existing proprietary platform to SWIFTNet, which is an open browser-based platform. This spending will continue in 2009. Spending on financial infrastructure is not related to the HKMA's own operations, but to providing and expanding payment and other systems to enable markets to function efficiently. These expenses are shown in Table 5. The HKMA also provides operational support to the Hong Kong Deposit Protection Board in the areas of investment, accounting and settlement on a cost-recovery basis endorsed by the Financial Secretary.

Table 3 Administrative expenditure (2008 and 2009 budgeted)

\$ million	2008 Budget*	2008 Actual	2009 Budget*
Staff costs	631		656
Salaries and other staff costs		584	
Retirement benefit costs		36	
Premises expenses			
Operating lease charges	5	5	7
Other premises expenses (including utility charges and management fees)	34	33	36
General operating costs			
Maintenance of office and computer equipment	35	33	35
Financial information and communication services (including trading, dealing terminals and data link charges)	36	29	40
External relations (including international meetings)	26	17	28
Professional and other services	17	14	21
Training	7	5	7
Others	5	4	6
Total HKMA administrative expenditure	796	760	836

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

Table 4 Expenses related to investigation of complaints about banking services (2008 and 2009 budgeted)

\$ million	2008 Budget*	2008 Actual*	2009 Budget
Handling of complaints about banking services			
Staff costs	-	-	84
Premises expenses	-	-	7
General operating costs			
Communication services	1	1	3
Professional and other services	17	16	43
Others	-	-	1
Total	18	17	138

* Met from savings in other areas through virement.

Table 5 Additional expenses (2008 and 2009 budgeted)

\$ million	2008 Budget*	2008 Actual	2009 Budget*
Subsidy to the Hong Kong Institute for Monetary Research	16	15	18
Premises expenses of international financial organisations in Hong Kong	26	26	26
Service fees for financial infrastructure	47	17	54

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

Professional and Corporate Services

In addition to investment income from managing the Exchange Fund, the HKMA earns revenue mainly through licence fees paid by Als, rental payments from tenants in Two International Finance Centre, and custodian and transaction fees from users of the CMU. The HKMA also receives reimbursement from the Hong Kong Deposit Protection Board for providing operational support to the Board according to section 6 of the Deposit Protection Scheme Ordinance. In 2009 licence fees are estimated at \$135.1 million (2008: \$141.3 million) and the other income components (excluding investment income) at \$116.1 million (2008: \$88.9 million), mainly due to increases in rental income as some of the leases in Two International Finance Centre have been renewed.

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

Events in the money markets led to some changes to the balance sheet of the Exchange Fund. In the last quarter of 2008, in response to capital inflows into the Hong Kong dollar and in accordance with the Currency Board system, the Exchange Fund bought US dollars against Hong Kong dollars, thus increasing the liquidity of the banking system. These changes were reflected on the liability side of the balance sheet in increases in the *Balance of the banking system* and *Exchange Fund Bills and Notes issued*. The US dollars received as a result of market operations were invested in different asset classes leading to corresponding increases in *Placements with banks and other financial institutions* and *Financial assets designated at fair value through profit or loss*, under which debt securities and equity investments purchased were grouped.

INFORMATION TECHNOLOGY

In 2008 the IT Division continued to upgrade infrastructure and application systems, including the Lotus Notes e-mail engine and related workflow applications. A "green-IT" initiative was launched to promote energy saving and waste reduction. The HKMA achieved the highest overall security maturity level of 5 in an IT security audit conducted by the Office of the Government Chief Information Officer.

The migration of the Reserves and Monetary Management System to a new hardware platform was completed in November. The Division continued to provide support to the migration of the RTGS system platform to SWIFTNet. It also helped develop an information system capable of generating statistics and processing information collected on complaints about banking services received by the HKMA.

SETTLEMENT SERVICES

The Settlement Section supports the reserves management, monetary operations and other activities of the HKMA requiring transfers of funds or assets of the Exchange Fund, and is responsible for ensuring that the settlement standards adopted by the HKMA are in line with the best market practice. It also provides professional advice to other departments of the HKMA on projects that have implications for settlement functions. For example, the Settlement Section was involved in supporting the implementation of the five temporary measures for providing liquidity assistance to licensed banks in October 2008.

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

OFFICE OF THE GENERAL COUNSEL

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

INTERNAL AUDIT

The Internal Audit Division performs independent assessment of the adequacy and effectiveness of risk management and control and governance processes, and advises on opportunities for improvement. The Division reports directly to the Chief Executive of the HKMA and the Audit Sub-Committee of EFAC.

During the year the Division co-ordinated the annual organisation-wide risk assessment exercise and reported the results to the Risk Committee. Using a risk-based approach, the Division conducted operational audits and system security reviews covering all the significant risks in various business units in the HKMA. The Division advised on major system development projects and responded to management requests on internal-control matters from time to time. The Division also reviewed the operations of the Hong Kong Deposit Protection Board and the Hong Kong Note Printing Limited.

The Division attaches great importance to keeping abreast of the latest development in practices in the internal audit profession and other central banks. In 2008 the Division received visitors from the State Administration of Foreign Exchange and another central bank to share views and experience in risk management and other issues. Arrangements were made to send the professional staff of the Division to attend training courses on the latest risk-management practices and audit techniques.

 Internal Audit

Professional and Corporate Services

RISK MANAGEMENT

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

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

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

The Committee meets regularly to review the risk assessments made by the business units and the adequacy of controls, and to identify potential or emerging risks and devise mitigating strategies.

EXTERNAL AUDITOR

In accordance with section 7 of the Exchange Fund Ordinance, the Audit Commission of the Government of the Hong Kong Special Administrative Region audits the financial statements of the Exchange Fund. The Commission does not charge for this service.

The Exchange Fund

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

Report of the Director of Audit



Audit Commission
The Government of the Hong Kong Special Administrative Region

Independent Audit Report

To the Financial Secretary

I certify that I have audited the financial statements of the Exchange Fund set out on pages 120 to 193, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2008, 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 2008 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 2009

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

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2008

(Expressed in millions of Hong Kong dollars)	Notes	Group	Fund	2007	2007
		2008	2008		
INCOME					
Interest income		37,491	47,567	35,665	45,222
Dividend income		8,219	7,036	8,442	7,266
Net realised and revaluation gains/(losses)		(115,604)	75,833	(115,587)	75,717
Net exchange gains/(losses)		(12,484)	18,729	(12,440)	18,713
Investment income/(losses)	4(a)	(82,378)	149,165	(83,920)	146,918
Bank licence fees		141	132	141	132
Other income		329	295	106	75
TOTAL INCOME/(LOSSES)		(81,908)	149,592	(83,673)	147,125
EXPENDITURE					
Interest expense	4(b)	(51,248)	(37,058)	(50,138)	(35,370)
Operating expenses	4(c)	(2,657)	(2,445)	(2,455)	(2,260)
Note and coin expenses	4(d)	(229)	(223)	(229)	(223)
Write back of impairment losses on loans/ (Impairment losses on loans)		(36)	5	-	-
TOTAL EXPENDITURE		(54,170)	(39,721)	(52,822)	(37,853)
SURPLUS/(DEFICIT) BEFORE SHARE OF PROFIT OF ASSOCIATE AND JOINT VENTURE		(136,078)	109,871	(136,495)	109,272
Share of profit of associate and joint venture, net of tax		2	8	-	-
SURPLUS/(DEFICIT) BEFORE TAXATION		(136,076)	109,879	(136,495)	109,272
Income tax		(35)	(86)	-	-
SURPLUS/(DEFICIT) FOR THE YEAR		(136,111)	109,793	(136,495)	109,272
ATTRIBUTABLE TO:					
Owner of the Fund		(136,131)	109,779	(136,495)	109,272
Minority interests		20	14	-	-
		(136,111)	109,793	(136,495)	109,272

The notes on pages 125 to 193 form part of these financial statements.

Exchange Fund – Balance Sheet

as at 31 December 2008

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2008	2007	2008	2007
ASSETS					
Cash and money at call	6	19,447	21,310	19,383	21,222
Placements with banks and other financial institutions	7	156,529	114,343	153,395	111,695
Derivative financial instruments	8(a)	9,967	3,786	7,729	3,129
Financial assets designated at fair value through profit or loss	9	1,347,499	1,253,442	1,347,499	1,253,442
Available-for-sale securities	10	2,545	4,531	493	493
Held-to-maturity securities	11	5,713	5,607	–	–
Loan portfolio	12	50,760	34,460	–	–
Gold	13	448	436	448	436
Other assets	14	19,578	19,664	17,792	18,329
Investments in subsidiaries	15	–	–	10,145	2,145
Interests in associate and joint venture	16	158	43	–	–
Property, plant and equipment	17(a)	786	816	584	595
Operating land lease prepayment	18	2,849	2,923	2,849	2,923
Intangible assets	19	15	13	15	13
TOTAL ASSETS		1,616,294	1,461,374	1,560,332	1,414,422
LIABILITIES AND EQUITY					
Certificates of Indebtedness	20	176,093	163,381	176,093	163,381
Government-issued currency notes and coins in circulation	20	8,266	7,545	8,266	7,545
Balance of the banking system	21	158,038	10,639	158,038	10,639
Derivative financial instruments	8(a)	4,149	733	3,934	610
Placements by banks and other financial institutions	22	13,613	–	13,613	–
Placements by other Hong Kong Special Administrative Region government funds	23	531,370	464,585	531,370	464,585
Placements by Hong Kong statutory bodies		74	30	74	30
Exchange Fund Bills and Notes issued	24	162,554	141,767	162,554	141,767
Other debt securities issued	25	42,786	33,291	–	–
Mortgage-backed securities issued	26	3,226	4,229	–	–
Other liabilities	27	31,570	14,277	25,905	8,885
Total liabilities		1,131,739	840,477	1,079,847	797,442
Accumulated surplus	28	484,461	620,592	480,485	616,980
Other reserves	28	(97)	126	–	–
Total equity attributable to owner of the Fund		484,364	620,718	480,485	616,980
Minority interests	28	191	179	–	–
Total equity		484,555	620,897	480,485	616,980
TOTAL LIABILITIES AND EQUITY		1,616,294	1,461,374	1,560,332	1,414,422

Joseph Yam

Monetary Authority
26 March 2009

The notes on pages 125 to 193 form part of these financial statements.

Exchange Fund – Statement of Changes in Equity

for the year ended 31 December 2008

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2008	2007	2008	2007
Total equity at 1 January		620,897	511,112	616,980	507,708
Net income/(losses) recognised directly in equity					
Available-for-sale securities					
– changes in fair value	28	(117)	18	–	–
– transfer to income and expenditure account on disposal	28	(25)	(22)	–	–
Cash flow hedges					
– changes in fair value	28	(72)	5	–	–
Currency translation difference					
– joint venture	28	(9)	–	–	–
Net income/(losses) for the year recognised directly in equity		(223)	1	–	–
Surplus/(Deficit) for the year	28	(136,111)	109,793	(136,495)	109,272
Total recognised income and expenditure for the year		(136,334)	109,794	(136,495)	109,272
Attributable to:					
– owner of the Fund		(136,354)	109,780	(136,495)	109,272
– minority interests		20	14	–	–
Dividends paid to minority interests	28	(8)	(9)	–	–
Total equity at 31 December	28	484,555	620,897	480,485	616,980

The notes on pages 125 to 193 form part of these financial statements.

Exchange Fund – Cash Flow Statement

for the year ended 31 December 2008

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2008	2007	2008	2007
Cash flows from operating activities					
Surplus/(Deficit) before share of profit of associate and joint venture		(136,078)	109,871	(136,495)	109,272
Adjustments for:					
Interest income	4(a)	(37,491)	(47,567)	(35,665)	(45,222)
Dividend income	4(a)	(8,219)	(7,036)	(8,442)	(7,266)
Net (gains)/losses on available-for-sale securities	4(a)	(26)	18	-	-
Interest expense	4(b)	51,248	37,058	50,138	35,370
Depreciation and amortisation	4(c)	142	149	110	116
Elimination of exchange differences and other non-cash items		2,679	(1,511)	2,702	(1,419)
Interest received		38,055	46,208	36,272	44,000
Interest paid		(51,273)	(65,967)	(50,201)	(64,401)
Dividends received		8,187	7,054	8,146	7,037
Income tax paid		(23)	(86)	-	-
		(132,799)	78,191	(133,435)	77,487
Change in fair value of derivatives and other debt securities issued		(1,237)	(1,922)	(1,287)	(1,848)
Change in placements with banks and other financial institutions		65	713	180	755
Change in financial assets designated at fair value through profit or loss		(142,551)	(129,170)	(142,551)	(129,170)
Change in loan portfolio		(16,337)	(2,074)	-	-
Change in gold		(12)	(106)	(12)	(106)
Change in other assets		(470)	618	(11)	807
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		13,433	7,158	13,433	7,158
Change in balance of the banking system		147,399	8,604	147,399	8,604
Change in trading liabilities		-	(2,096)	-	(2,096)
Change in placements by banks and other financial institutions		13,613	(7,572)	13,613	(7,572)
Change in placements by other Hong Kong Special Administrative Region government funds		66,785	140,055	66,785	140,055
Change in placements by Hong Kong statutory bodies		44	4	44	4
Change in Exchange Fund Bills and Notes issued		20,787	12,628	20,787	12,628
Change in other liabilities		17,355	(1,058)	17,072	(1,044)
Net cash from/(used in) operating activities		(13,925)	103,973	2,017	105,662

Exchange Fund – Cash Flow Statement (cont.)

for the year ended 31 December 2008

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2008	2007	2008	2007
Cash flows from investing activities					
Loan to a subsidiary		-	-	(8,000)	-
Investment in joint venture		(122)	-	-	-
Proceeds from sale or redemption of available-for-sale securities		18,566	24,138	-	-
Purchase of available-for-sale securities		(17,311)	(23,477)	-	-
Proceeds from redemption of held-to-maturity securities		3,538	3,242	-	-
Purchase of held-to-maturity securities		(3,048)	(4,081)	-	-
Purchase of property, plant and equipment and intangible assets		(40)	(29)	(27)	(17)
Dividends received from subsidiaries		-	-	259	261
Net cash from/(used in) investing activities		1,583	(207)	(7,768)	244
Cash flows from financing activities					
Proceeds from issue of other debt securities		24,349	16,356	-	-
Redemption of other debt securities issued		(16,343)	(12,341)	-	-
Redemption of mortgage-backed securities issued		(1,055)	(1,144)	-	-
Dividends paid to minority interests		(8)	(9)	-	-
Net cash from/(used in) financing activities		6,943	2,862	-	-
Net increase/(decrease) in cash and cash equivalents		(5,399)	106,628	(5,751)	105,906
Cash and cash equivalents at 1 January		207,487	99,437	204,990	97,665
Effect of foreign exchange rate changes		(2,708)	1,422	(2,702)	1,419
Cash and cash equivalents at 31 December	29	199,380	207,487	196,537	204,990

The notes on pages 125 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 interests in an associate and a joint venture. The principal activities of the subsidiaries, the associate and the joint venture 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 holds shares in Hong Kong Exchanges and Clearing Limited acquired by the Hong Kong Special Administrative Region (HKSAR) Government for the account of the Fund for strategic purposes. The balance of the Fund's assets constitutes the Investment Portfolio. Segment information is set out in note 30.

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 36 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 and joint venture

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.

A joint venture is an entity which operates under a contractual arrangement between the Group and other parties, where the contractual arrangement establishes that the Group and one or more of the other parties share joint control over the economic activity of the entity.

An investment in an associate or a joint venture 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 net assets of the associate or the joint venture. The Group income and expenditure account includes the Group's share of the post-tax results of the associate and the joint venture for the year.

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

In the Fund balance sheet, its investments in associate and joint venture are 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).

2.5.2.4 Held-to-maturity securities

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

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

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

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

2.5.2.5 Available-for-sale securities

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

Available-for-sale securities are carried at fair value. Unrealised gains and losses arising from changes in the fair value are recognised directly in the revaluation reserve, except for 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 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.

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.

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

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

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

2.5.3 Fair value measurement principles

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

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

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

2.5.4 Derecognition

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

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

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.

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

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

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).

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 the measurement principles as stated in note 2.5.2.2. 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 the measurement principles as stated in note 2.5.2.2. Where cash collateral is received, a liability is recorded in respect of the cash received in “placements by banks and other financial institutions”. Securities received as collateral are not recognised in the financial statements.

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

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

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.

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 (net of any principal repayment and amortisation) 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, investments in associate and joint venture, property, plant and equipment and intangible assets, are reviewed at each balance sheet date to identify any indication of impairment.

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

2.15 Cash equivalents

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

2.16 Revenue and expenditure recognition

2.16.1 Interest income and expense

Interest on the majority of the placements by other HKSAR government funds is payable at a fixed rate determined annually (note 23). 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 rental income, income from the sale of withdrawn coins and Central Moneymarkets Unit fee income. Rental income is recognised on a straight-line basis over the lease term. The other income is accounted for in the period when it becomes receivable.

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

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

2.16.4 Contributions to staff retirement schemes

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

2.16.5 Rental payments under operating leases

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

2.16.6 Income tax

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

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

2.17 Foreign currency translation

The financial statements are presented in Hong Kong dollars, which is the Fund's functional currency.

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.

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

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

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 or a joint venture in which the Group is a venturer;
- (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, including the Backing Portfolio;
- management of funds representing the general reserve assets of the Fund, including the Investment Portfolio and 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 30. 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.

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

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

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 changes to the accounting policies applied in these financial statements for the years presented as a result of these developments.

Amendments to HKAS 39, issued in October 2008, permit an entity in rare circumstances to reclassify non-derivative securities out of the trading category. The amendments also permit reclassification of a financial asset from the available-for-sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity. These amendments do not have any impact on the financial statements as the Group has not reclassified any financial assets.

The Group has not applied any new standard that is not yet effective for the current accounting period (see note 37).

4 INCOME AND EXPENDITURE

(a) Investment income/(losses)

	Group		Fund	
	2008	2007	2008	2007
Interest income				
– from derivative financial instruments	185	134	185	134
– from financial assets designated at fair value through profit or loss	31,721	37,516	31,721	37,516
– from other financial assets	5,585	9,917	3,759	7,572
	37,491	47,567	35,665	45,222
Dividend income				
– from financial assets designated at fair value through profit or loss	8,162	6,994	8,162	6,994
– from other financial assets	57	42	14	13
– from subsidiaries	–	–	266	259
	8,219	7,036	8,442	7,266
Net realised and revaluation gains/(losses)				
– on derivative financial instruments	(12,984)	2,809	(14,471)	2,323
– on financial assets and financial liabilities designated at fair value through profit or loss	(102,646)	73,042	(101,116)	73,394
– on available-for-sale securities	26	(18)	–	–
	(115,604)	75,833	(115,587)	75,717
Net exchange gains/(losses)	(12,484)	18,729	(12,440)	18,713
Total	(82,378)	149,165	(83,920)	146,918

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

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

(b) Interest expense

	Group		Fund	
	2008	2007	2008	2007
Interest expense on derivative financial instruments	–	8	–	8
Interest expense on Exchange Fund Bills and Notes and other debt securities issued designated at fair value through profit or loss and trading liabilities	2,725	5,082	2,326	4,902
Interest expense on other financial liabilities	48,523	31,968	47,812	30,460
Total	51,248	37,058	50,138	35,370
Comprises:				
Interest on placements by other HKSAR government funds				
– at rates determined by reference to the investment income of the Fund	–	6,354	–	6,354
– at a fixed rate determined annually	46,360	21,261	46,360	21,261
– at market-based rates	4	77	4	77
Interest on Exchange Fund Bills and Notes issued	2,326	4,898	2,326	4,898
Other interest expense	2,558	4,468	1,448	2,780
	51,248	37,058	50,138	35,370

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

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

(c) Operating expenses

	Group		Fund	
	2008	2007	2008	2007
Staff costs				
Salaries and other staff costs	713	645	584	528
Retirement benefit costs	43	37	36	30
Premises and equipment expenses				
Depreciation and amortisation	142	149	110	116
Rental expenses under operating leases	28	21	28	21
Other premises expenses	45	40	36	33
General operating costs				
Maintenance of office and computer equipment	39	38	33	31
Financial information and communication services	36	33	30	28
External relations	18	16	17	15
Service fees for financial infrastructure	18	29	17	29
Other professional services	43	24	30	15
Training	6	5	5	4
Others	14	13	19	17
Investment management and custodian fees				
Management and custodian fees	752	882	752	882
Transaction costs	268	293	266	291
Withholding tax	481	203	481	203
Others	11	17	11	17
Total	2,657	2,445	2,455	2,260

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	
	2008	2007
Fixed pay	58.7	53.1
Variable pay	16.0	14.4
Other benefits	6.5	5.5
	81.2	73.0

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	
	2008	2007
1,500,000 or below	1	–
1,500,001 to 2,000,000	1	–
3,000,001 to 3,500,000	1	1
3,500,001 to 4,000,000	3	4
4,000,001 to 4,500,000	5	5
4,500,001 to 5,000,000	2	1
5,000,001 to 5,500,000	–	1
6,000,001 to 6,500,000	–	1
6,500,001 to 7,000,000	1	1
7,000,001 to 7,500,000	2	–
10,000,001 to 10,500,000	–	1
11,500,001 to 12,000,000	1	–
	17	15

(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

		Group – 2008						
	Notes	Total	Trading financial instruments (including hedging instruments)	Financial assets and financial liabilities designated at fair value through profit or loss	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	19,447	-	-	19,447	-	-	-
Placements with banks and other financial institutions	7	156,529	-	-	156,529	-	-	-
Derivative financial instruments	8(a)	9,967	9,967	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9	1,347,499	-	1,347,499	-	-	-	-
Available-for-sale securities	10	2,545	-	-	-	-	2,545	-
Held-to-maturity securities	11	5,713	-	-	-	5,713	-	-
Loan portfolio	12	50,760	-	-	50,760	-	-	-
Other assets	14	19,578	-	-	19,578	-	-	-
Financial assets		1,612,038	9,967	1,347,499	246,314	5,713	2,545	-
Certificates of Indebtedness	20	176,093	-	-	-	-	-	176,093
Government-issued currency notes and coins in circulation	20	8,266	-	-	-	-	-	8,266
Balance of the banking system	21	158,038	-	-	-	-	-	158,038
Derivative financial instruments	8(a)	4,149	4,149	-	-	-	-	-
Placements by banks and other financial institutions	22	13,613	-	-	-	-	-	13,613
Placements by other HKSAR government funds	23	531,370	-	-	-	-	-	531,370
Placements by Hong Kong statutory bodies		74	-	-	-	-	-	74
Exchange Fund Bills and Notes issued	24	162,554	-	162,554	-	-	-	-
Other debt securities issued	25	42,786	-	4,713	-	-	-	38,073
Mortgage-backed securities issued	26	3,226	-	-	-	-	-	3,226
Other liabilities	27	31,570	-	-	-	-	-	31,570
Financial liabilities		1,131,739	4,149	167,267	-	-	-	960,323

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

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

				Group – 2007				
	Notes	Total	Trading financial instruments (including hedging instruments)	Financial assets and financial liabilities designated at fair value through profit or loss	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	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	23	464,585	–	–	–	–	–	464,585
Placements by Hong Kong statutory bodies		30	–	–	–	–	–	30
Exchange Fund Bills and Notes issued	24	141,767	–	141,767	–	–	–	–
Other debt securities issued	25	33,291	–	4,971	–	–	–	28,320
Mortgage-backed securities issued	26	4,229	–	–	–	–	–	4,229
Other liabilities	27	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.)

			Fund – 2008					
	Notes	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	19,383	-	-	19,383	-	-	-
Placements with banks and other financial institutions	7	153,395	-	-	153,395	-	-	-
Derivative financial instruments	8(a)	7,729	7,729	-	-	-	-	-
Financial assets designated at fair value through profit or loss	9	1,347,499	-	1,347,499	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Other assets	14	17,792	-	-	17,792	-	-	-
Financial assets		1,546,291	7,729	1,347,499	190,570	-	493	-
Certificates of Indebtedness	20	176,093	-	-	-	-	-	176,093
Government-issued currency notes and coins in circulation	20	8,266	-	-	-	-	-	8,266
Balance of the banking system	21	158,038	-	-	-	-	-	158,038
Derivative financial instruments	8(a)	3,934	3,934	-	-	-	-	-
Placements by banks and other financial institutions	22	13,613	-	-	-	-	-	13,613
Placements by other HKSAR government funds	23	531,370	-	-	-	-	-	531,370
Placements by Hong Kong statutory bodies		74	-	-	-	-	-	74
Exchange Fund Bills and Notes issued	24	162,554	-	162,554	-	-	-	-
Other liabilities	27	25,905	-	-	-	-	-	25,905
Financial liabilities		1,079,847	3,934	162,554	-	-	-	913,359

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

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

				Fund – 2007				
	Notes	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	23	464,585	–	–	–	–	–	464,585
Placements by Hong Kong statutory bodies		30	–	–	–	–	–	30
Exchange Fund Bills and Notes issued	24	141,767	–	141,767	–	–	–	–
Other liabilities	27	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.)

6 CASH AND MONEY AT CALL

	Group		Fund	
	2008	2007	2008	2007
At amortised cost				
Balance with central banks	1,231	836	1,231	836
Balance with banks	18,216	20,474	18,152	20,386
Total	19,447	21,310	19,383	21,222

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2008	2007	2008	2007
At amortised cost				
Placements in respect of reverse repurchase agreements				
– with central banks	17,489	1,992	17,489	1,992
– with banks and other financial institutions	6,119	5,537	6,119	5,537
Other placements with banks	132,921	106,814	129,787	104,166
Total	156,529	114,343	153,395	111,695

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 with settlement at a future date.

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, and currency and bond options 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 35.

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			
	2008		2007		2008		2007	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	1,276	150	529	120	1,059	-	338	-
Currency derivatives								
Forward foreign exchange contracts	5,506	3,917	2,718	477	5,504	3,917	2,718	477
Others								
Stock index futures contracts	1,113	-	73	132	1,113	-	73	132
Bond futures contracts	53	17	-	1	53	17	-	1
	7,948	4,084	3,320	730	7,729	3,934	3,129	610
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	1,866	-	451	3	-	-	-	-
Currency derivatives								
Currency swap contracts	124	53	7	-	-	-	-	-
	1,990	53	458	3	-	-	-	-
Derivatives designated as hedging instruments in cash flow hedges								
Currency derivatives								
Currency swap contracts	29	12	8	-	-	-	-	-
Total	9,967	4,149	3,786	733	7,729	3,934	3,129	610

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 Notional amounts with remaining life of									
	Total	Up to 3 months	2008 3-12 months	1-5 years	Over 5 years	Total	Up to 3 months	2007 3-12 months	1-5 years	Over 5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	48,418	20,206	8,758	16,209	3,245	58,452	11,127	22,920	21,495	2,910
Currency derivatives										
Forward foreign exchange contracts	150,129	145,494	4,635	-	-	161,915	161,857	58	-	-
Others										
Stock index futures contracts	53,812	53,812	-	-	-	22,790	22,790	-	-	-
Bond futures contracts	17,913	17,913	-	-	-	2,141	2,141	-	-	-
	270,272	237,425	13,393	16,209	3,245	245,298	197,915	22,978	21,495	2,910
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	25,357	3,287	3,502	13,574	4,994	25,799	1,575	6,717	14,518	2,989
Currency derivatives										
Currency swap contracts	4,953	227	-	4,266	460	691	-	425	266	-
	30,310	3,514	3,502	17,840	5,454	26,490	1,575	7,142	14,784	2,989
Derivatives designated as hedging instruments in cash flow hedges										
Currency derivatives										
Currency swap contracts	14,770	253	-	-	14,517	5,460	-	-	-	5,460
Total	315,352	241,192	16,895	34,049	23,216	277,248	199,490	30,120	36,279	11,359

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	Up to 3 months	2008 3-12 months	1-5 years	Over 5 years	Total	Up to 3 months	2007 3-12 months	1-5 years	Over 5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	7,550	-	-	4,550	3,000	7,739	500	900	4,339	2,000
Currency derivatives										
Forward foreign exchange contracts	140,214	136,717	3,497	-	-	161,857	161,857	-	-	-
Others										
Stock index futures contracts	53,812	53,812	-	-	-	22,790	22,790	-	-	-
Bond futures contracts	17,913	17,913	-	-	-	2,141	2,141	-	-	-
Total	219,489	208,442	3,497	4,550	3,000	194,527	187,288	900	4,339	2,000

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

	Group and Fund	
	2008	2007
At fair value		
Debt securities		
Treasury bills and commercial paper		
Unlisted	285,076	136,767
Certificates of deposit		
Unlisted	-	6,236
Other debt securities		
Listed outside Hong Kong	416,601	343,356
Unlisted	449,606	436,523
Total debt securities	1,151,283	922,882
Equity securities		
Listed		
– in Hong Kong	92,870	184,569
– outside Hong Kong	103,346	145,991
Total equity securities	196,216	330,560
Total	1,347,499	1,253,442

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	
	2008	2007	2008	2007
Debt securities, at fair value				
Listed				
– in Hong Kong	49	462	–	–
– outside Hong Kong	–	128	–	–
Unlisted	1,161	2,666	–	–
	1,210	3,256	–	–
Equity securities				
Listed in Hong Kong, at fair value	842	782	–	–
Unlisted, at cost	493	493	493	493
Total	2,545	4,531	493	493

The Group's investment in unlisted equity securities at 31 December 2008 represents a holding of 4,285 shares (2007: 4,285 shares) in the Bank for International Settlements (also see note 33(a)) with a nominal value of 5,000 Special Drawing Rights each. These shares are 25% paid. As these shares are not freely transferable, no estimate of their fair value is made.

11 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2008	2007	2008	2007
At amortised cost				
Debt securities				
Listed				
– in Hong Kong	1,147	620	–	–
– outside Hong Kong	1,138	757	–	–
Unlisted	3,428	4,230	–	–
Total	5,713	5,607	–	–

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

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

12 LOAN PORTFOLIO

	Group		Fund	
	2008	2007	2008	2007
Mortgage loans, at amortised cost	49,408	32,669	–	–
Non-mortgage loans, at amortised cost	1,403	1,805	–	–
Allowance for loan impairment	(51)	(14)	–	–
Total	50,760	34,460	–	–

13 GOLD

	Group and Fund	
	2008	2007
Gold, at market value		
66,798 ounces (2007: 66,798 ounces)	448	436

14 OTHER ASSETS

	Group		Fund	
	2008	2007	2008	2007
Interest and dividends receivable	11,306	11,891	10,616	11,164
Unsettled sales and redemption of securities	6,084	5,895	6,084	5,895
Prepayments, receivables and other assets	1,882	1,579	815	971
Staff housing loans	277	299	277	299
Deferred tax assets	29	–	–	–
Total	19,578	19,664	17,792	18,329

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

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

15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2008	2007
Unlisted shares, at cost	2,145	2,145
Loan to a subsidiary	8,000	–
Total	10,145	2,145

The following is a list of the principal subsidiaries as at 31 December 2008 and 2007:

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 (2007: HK\$1 billion), which is callable from the Fund.

The loan to a subsidiary is an unsecured loan to the HKMC having no fixed term of repayment. Interest is charged at prevailing market rates.

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

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

16 INTERESTS IN ASSOCIATE AND JOINT VENTURE

	Group		Fund	
	2008	2007	2008	2007
Associate				
Unlisted shares, at cost	–	–	–	–
Share of net assets	45	43	–	–
	45	43	–	–
Joint venture				
Unlisted shares, at cost	120	–	–	–
Due from a joint venture	2	–	–	–
Currency translation difference	(9)	–	–	–
	113	–	–	–
Total	158	43	–	–

Investment in associate comprises unlisted shares of Hong Kong Interbank Clearing Limited directly held by the Fund at a cost of HK\$5,000 (2007: HK\$5,000). Investment in joint venture comprises unlisted shares of Cagamas HKMC Berhad held by the Group through the HKMC. Details of the associate and joint venture are as follows:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Group's interest in equity capital
Associate				
Hong Kong Interbank Clearing Limited	Hong Kong	Interbank clearing	HK\$10,000	50%
Joint venture				
Cagamas HKMC Berhad	Malaysia	Mortgage guarantee business	RM100,000,000	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 2007	622	635	1,257
Additions	2	24	26
Disposals	–	(20)	(20)
At 31 December 2007	624	639	1,263
At 1 January 2008	624	639	1,263
Additions	–	31	31
Disposals	–	(4)	(4)
At 31 December 2008	624	666	1,290
Accumulated depreciation			
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
At 1 January 2008	61	386	447
Charge for the year	14	47	61
Written back on disposal	–	(4)	(4)
At 31 December 2008	75	429	504
Net book value			
At 31 December 2008	549	237	786
At 31 December 2007	563	253	816

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 2007	612	211	823
Additions	–	14	14
Disposals	–	(16)	(16)
At 31 December 2007	612	209	821
At 1 January 2008	612	209	821
Additions	–	18	18
Disposals	–	(3)	(3)
At 31 December 2008	612	224	836
Accumulated depreciation			
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
At 1 January 2008	58	168	226
Charge for the year	13	16	29
Written back on disposal	–	(3)	(3)
At 31 December 2008	71	181	252
Net book value			
At 31 December 2008	541	43	584
At 31 December 2007	554	41	595

(b) The net book value of premises comprises:

	Group		Fund	
	2008	2007	2008	2007
In Hong Kong				
Buildings situated on land held on medium-term leases (between 10 and 50 years)	525	539	517	530
Outside Hong Kong				
Freehold land and the building situated thereon	24	24	24	24
Total	549	563	541	554

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

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

18 OPERATING LAND LEASE PREPAYMENT

	Group and Fund	
	2008	2007
Cost		
At 1 January and 31 December	3,231	3,231
Accumulated amortisation		
At 1 January	308	234
Charge for the year	74	74
At 31 December	382	308
Net book value		
At 31 December	2,849	2,923

19 INTANGIBLE ASSETS

	Group and Fund	
	Computer software licences and system development costs	
	2008	2007
Cost		
At 1 January	237	234
Additions	9	3
At 31 December	246	237
Accumulated amortisation		
At 1 January	224	212
Charge for the year	7	12
At 31 December	231	224
Net book value		
At 31 December	15	13

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	
	2008	2007	2008	2007
Carrying amount	176,093	163,381	8,266	7,545
Reconciliation with face value:				
Hong Kong dollar face value	HK\$177,225	HK\$163,435	HK\$8,319	HK\$7,547
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\$22,721	US\$20,953	US\$1,067	US\$968
Market exchange rate for translation into Hong Kong dollars	US\$1 = HK\$7.7502	US\$1 = HK\$7.7974	US\$1 = HK\$7.7502	US\$1 = HK\$7.7974
Carrying amount	HK\$176,093	HK\$163,381	HK\$8,266	HK\$7,545

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 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2008	2007
At amortised cost		
Placements by banks	13,613	–

23 PLACEMENTS BY OTHER HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT FUNDS

	Group and Fund	
	2008	2007
Placements with interest payable at a fixed rate determined annually		
General Revenue Account	275,773	216,956
Land Fund	164,650	150,467
Capital Works Reserve Fund	56,062	65,069
Civil Service Pension Reserve Fund	20,254	18,509
Disaster Relief Fund	38	16
Innovation and Technology Fund	4,298	4,474
Lotteries Fund	7,033	6,062
Capital Investment Fund	1,301	1,221
Loan Fund	1,644	1,483
	531,053	464,257
Placements with interest payable at market-based rates		
General Revenue Account	253	269
Loan Fund	19	16
Capital Works Reserve Fund	45	43
	317	328
Total	531,370	464,585

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 has been fixed at 6.8% per annum for 2009 and 9.4% for 2008 (2007: 7%).

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

24 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group and Fund	
	2008	2007
At fair value		
Exchange Fund Bills and Notes issued		
Exchange Fund Bills	90,745	76,206
Exchange Fund Notes	72,809	66,399
	163,554	142,605
Exchange Fund Bills and Notes held		
Exchange Fund Bills	(1,000)	(500)
Exchange Fund Notes	-	(338)
	(1,000)	(838)
Total	162,554	141,767

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 2008, there was no short position in EFBN (2007: Nil).

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			
	2008		2007	
	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Issued by Currency Board Operations segment				
Redemption amount at 1 January	76,612	64,300	70,088	61,700
Issuance	261,387	16,400	210,787	17,000
Redemption	(247,246)	(13,800)	(204,263)	(14,400)
Redemption amount at 31 December	90,753	66,900	76,612	64,300
Long positions held by Financial Stability and Other Activities segment				
Redemption amount at 31 December	(1,000)	–	(500)	(331)
Total redemption amount	89,753	66,900	76,112	63,969
Carrying amount, at fair value	89,745	72,809	75,706	66,061
Difference	8	(5,909)	406	(2,092)

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

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

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

25 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2008	2007	2008	2007
Debt securities issued, carried at amortised cost				
Notes	8,211	3,948	–	–
Debt securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk				
Notes	29,862	24,372	–	–
	38,073	28,320	–	–
Debt securities issued, designated at fair value through profit or loss				
Notes	4,713	4,971	–	–
Total	42,786	33,291	–	–

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	
	2008	2007	2008	2007
Total debt securities issued				
Redemption amount at 1 January	32,938	28,867	–	–
Issuance	24,378	16,412	–	–
Redemption	(16,343)	(12,341)	–	–
Exchange difference	(34)	–	–	–
Redemption amount at 31 December	40,939	32,938	–	–
Carrying amount	42,786	33,291	–	–
Difference	(1,847)	(353)	–	–
Debt securities issued, designated at fair value through profit or loss				
Redemption amount	4,703	5,015	–	–
Carrying amount, at fair value	4,713	4,971	–	–
Difference	(10)	44	–	–

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

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

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

26 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2008	2007	2008	2007
Mortgage-backed securities issued, carried at amortised cost	1,258	1,663	–	–
Mortgage-backed securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk	1,968	2,566	–	–
Total	3,226	4,229	–	–

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	
	2008	2007	2008	2007
Total mortgage-backed securities issued				
Redemption amount at 1 January	4,203	5,347	–	–
Redemption	(1,055)	(1,144)	–	–
Redemption amount at 31 December	3,148	4,203	–	–
Carrying amount	3,226	4,229	–	–
Difference	(78)	(26)	–	–

27 OTHER LIABILITIES

	Group		Fund	
	2008	2007	2008	2007
Unsettled purchases of securities	24,900	7,912	24,900	7,912
Accrued charges and other liabilities	5,723	5,356	605	521
Interest payable	865	924	400	452
Tax payable	53	22	–	–
Deferred tax liabilities	29	63	–	–
Total	31,570	14,277	25,905	8,885

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

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

28 EQUITY

	Group		Fund	
	2008	2007	2008	2007
Attributable to owner of the Fund				
Accumulated surplus				
At 1 January	620,592	510,813	616,980	507,708
Surplus/(Deficit) for the year	(136,131)	109,779	(136,495)	109,272
At 31 December	484,461	620,592	480,485	616,980
Other reserves				
Revaluation reserve				
At 1 January	126	125	-	-
Net fair value gains/(losses), net of tax				
– on available-for-sale securities	(117)	18	-	-
– on cash flow hedges	(72)	5	-	-
Net gains transferred to income and expenditure account on disposal				
– on available-for-sale securities	(25)	(22)	-	-
At 31 December	(88)	126	-	-
Translation reserve				
At 1 January	-	-	-	-
Currency translation difference				
– joint venture	(9)	-	-	-
At 31 December	(9)	-	-	-
	(97)	126	-	-
	484,364	620,718	480,485	616,980
Minority interests				
At 1 January	179	174	-	-
Surplus for the year	20	14	-	-
Dividends paid to minority interests	(8)	(9)	-	-
At 31 December	191	179	-	-
Total	484,555	620,897	480,485	616,980

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

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

29 NOTES TO THE CASH FLOW STATEMENT

Analysis of cash and cash equivalents in the cash flow statement

	Group		Fund	
	2008	2007	2008	2007
Cash and money at call	19,447	21,310	19,383	21,222
Placements with banks and other financial institutions	155,574	113,324	152,795	110,915
Treasury bills and commercial paper	24,359	68,955	24,359	68,955
Certificates of deposit	–	3,898	–	3,898
Total	199,380	207,487	196,537	204,990

Reconciliation with the balance sheet

	Notes	Group		Fund	
		2008	2007	2008	2007
Amounts shown in the balance sheet					
Cash and money at call	6	19,447	21,310	19,383	21,222
Placements with banks and other financial institutions	7	156,529	114,343	153,395	111,695
Financial assets designated at fair value through profit or loss					
Treasury bills and commercial paper	9	285,076	136,767	285,076	136,767
Certificates of deposit	9	–	6,236	–	6,236
		461,052	278,656	457,854	275,920
Less: Amounts with original maturity beyond 3 months		(261,672)	(71,169)	(261,317)	(70,930)
Cash and cash equivalents in the cash flow statement		199,380	207,487	196,537	204,990

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

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

30 SEGMENT REPORTING

The activities of the Group comprise the following business segments:

- management of funds under the Currency Board Operations, including the Backing Portfolio;
- management of funds representing the general reserve assets of the Fund, including the Investment Portfolio and 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.

	Group									
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Total	
	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007
Income/(Losses)	22,897	22,181	(107,379)	123,386	(84,482)	145,567	2,574	4,025	(81,908)	149,592
Expenditure										
Interest expense	2,325	4,902	47,810	30,457	50,135	35,359	1,113	1,699	51,248	37,058
Other expenses (note 30(b))	-	-	-	-	1,637	1,499	1,285	1,164	2,922	2,663
	2,325	4,902	47,810	30,457	51,772	36,858	2,398	2,863	54,170	39,721
Surplus/(Deficit) before share of profit of associate and joint venture	20,572	17,279	(155,189)	92,929	(136,254)	108,709	176	1,162	(136,078)	109,871
Share of profit of associate and joint venture	-	-	-	-	-	-	2	8	2	8
Surplus/(Deficit) before taxation	20,572	17,279	(155,189)	92,929	(136,254)	108,709	178	1,170	(136,076)	109,879
Income tax	-	-	-	-	-	-	(35)	(86)	(35)	(86)
Surplus/(Deficit) for the year	20,572	17,279	(155,189)	92,929	(136,254)	108,709	143	1,084	(136,111)	109,793
Attributable to:										
Owner of the Fund	20,572	17,279	(155,189)	92,929	(136,254)	108,709	123	1,070	(136,131)	109,779
Minority interests	-	-	-	-	-	-	20	14	20	14
	20,572	17,279	(155,189)	92,929	(136,254)	108,709	143	1,084	(136,111)	109,793

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

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

	Group											
					Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Re-allocation (note 30(c) & (d))		Total	
	Currency Board Operations		Reserves Management									
	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007
Assets												
Backing Assets												
Investment in designated US dollar assets	566,950	355,174	-	-	566,950	355,174	-	-	-	-	566,950	355,174
Interest receivable on designated US dollar assets	1,976	2,226	-	-	1,976	2,226	-	-	-	-	1,976	2,226
Net accounts payable	(14,328)	-	-	-	(14,328)	-	-	-	14,328	-	-	-
Other investments	-	-	946,096	1,018,591	946,096	1,018,591	71,054	61,245	(1,000)	(838)	1,016,150	1,078,998
Other assets	-	-	22,238	14,416	22,238	14,416	8,022	6,115	958	4,445	31,218	24,976
TOTAL ASSETS	554,598	357,400	968,334	1,033,007	1,522,932	1,390,407	79,076	67,360	14,286	3,607	1,616,294	1,461,374
Liabilities												
Monetary Base												
Certificates of Indebtedness	176,093	163,381	-	-	176,093	163,381	-	-	-	-	176,093	163,381
Government-issued currency notes and coins in circulation	8,266	7,545	-	-	8,266	7,545	-	-	-	-	8,266	7,545
Balance of the banking system	158,038	10,639	-	-	158,038	10,639	-	-	-	-	158,038	10,639
Exchange Fund Bills and Notes issued	163,554	142,605	-	-	163,554	142,605	-	-	(1,000)	(838)	162,554	141,767
Interest payable on Exchange Fund Notes	398	462	-	-	398	462	-	-	-	-	398	462
Net accounts receivable	(958)	(4,445)	-	-	(958)	(4,445)	-	-	958	4,445	-	-
Other debt securities issued	-	-	-	-	-	-	42,786	33,291	-	-	42,786	33,291
Mortgage-backed securities issued	-	-	-	-	-	-	3,226	4,229	-	-	3,226	4,229
Placements by banks and other financial institutions	-	-	13,613	-	13,613	-	-	-	-	-	13,613	-
Placements by other HKSAR government funds	-	-	531,370	464,585	531,370	464,585	-	-	-	-	531,370	464,585
Placements by Hong Kong statutory bodies	-	-	-	-	-	-	74	30	-	-	74	30
Other liabilities	-	-	14,999	8,940	14,999	8,940	5,994	5,608	14,328	-	35,321	14,548
Total liabilities	505,391	320,187	559,982	473,525	1,065,373	793,712	52,080	43,158	14,286	3,607	1,131,739	840,477

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 30(c) & (d))		Total	
	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007
Accumulated surplus												
At 1 January	37,213	35,201	559,482	464,752	596,695	499,953	23,897	10,860	-	-	620,592	510,813
Surplus/(Deficit) for the year attributable to owner of the Fund	20,572	17,279	(155,189)	92,929	(136,254)	108,709	123	1,070	-	-	(136,131)	109,779
Transfer between Currency Board Operations and general reserves (note 30(e))	(8,578)	(15,267)	4,059	1,801	(2,882)	(11,967)	2,882	11,967	-	-	-	-
At 31 December	49,207	37,213	408,352	559,482	457,559	596,695	26,902	23,897	-	-	484,461	620,592
Other reserves	-	-	-	-	-	-	(97)	126	-	-	(97)	126
Minority interests	-	-	-	-	-	-	191	179	-	-	191	179
Total equity	49,207	37,213	408,352	559,482	457,559	596,695	26,996	24,202	-	-	484,555	620,897
TOTAL LIABILITIES AND EQUITY	554,598	357,400	968,334	1,033,007	1,522,932	1,390,407	79,076	67,360	14,286	3,607	1,616,294	1,461,374

(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.

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

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

(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 2008, deduction from the Backing Assets comprises:

- “other liabilities” of HK\$14,328 million (2007: Nil) – Accounts payable for unsettled purchases of securities are included in “net accounts payable” to offset corresponding investments in the Backing Assets.

As at 31 December 2008, deductions from the Monetary Base comprise:

- “other assets” of HK\$958 million (2007: HK\$4,445 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\$11 million (2007: HK\$3 million) and revaluation gains of HK\$947 million (2007: HK\$209 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 are included in “net accounts receivable” to reduce the Monetary Base. There was no such receivable at 31 December 2008 (2007: HK\$4,233 million).

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

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

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

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

31 PLEDGED ASSETS

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

		Group		Fund	
	Notes	2008	2007	2008	2007
Secured liabilities					
Stock index futures contracts – notional amount	8(b)	53,812	22,790	53,812	22,790
Bond futures contracts – notional amount	8(b)	17,913	2,141	17,913	2,141
Mortgage-backed securities issued	26	3,226	4,229	–	–
Assets pledged					
Financial assets designated at fair value through profit or loss		8,884	1,777	8,884	1,777
Held-to-maturity securities		445	106	–	–
Placements with banks		36	310	–	–
Mortgage loans		2,622	3,722	–	–

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.)

32 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	
	2008	2007	2008	2007
Contracted for	48	–	6	–
Authorised but not yet contracted for	189	79	159	64
	237	79	165	64

(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 2008, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$4,059 million equivalent (2007: HK\$4,189 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2008, there was no outstanding balance due from the IMF under this NAB facility (2007: 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 (2007: 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 2008, there was no outstanding balance due from the HKDPB under this facility (2007: Nil).

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

The Fund has provided the HKMC with a revolving credit facility of HK\$30 billion (2007: HK\$10 billion) at prevailing market interest rates. As at 31 December 2008, there was an outstanding balance due from the HKMC of HK\$8 billion (2007: Nil) (note 15) under this facility.

(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\$44,564 million equivalent (2007: HK\$44,835 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2008, there was no outstanding transaction with any central bank under this arrangement (2007: 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 2008, the total future minimum lease payments under non-cancellable operating leases of premises were payable as follows:

	Group and Fund	
	2008	2007
Not later than one year	32	26
Later than one year and not later than five years	97	101
Later than five years	2	9
Total	131	136

33 CONTINGENT LIABILITIES

- (a) At 31 December 2008, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$192 million equivalent (2007: 16.1 million Special Drawing Rights or HK\$198 million equivalent), in respect of the uncalled portion of its 4,285 shares (2007: 4,285 shares) in the Bank for International Settlements (note 10).
- (b) To further strengthen confidence in Hong Kong's banking system, the Financial Secretary announced on 14 October 2008 the use of the Fund to guarantee the repayment of all customer deposits held with all authorized institutions in Hong Kong. This guarantee covers all protected deposits as defined in the Deposit Protection Scheme Ordinance, were the Ordinance to apply to all authorized institutions including licensed banks, restricted licence banks and deposit-taking companies. It will cover the amount of deposits in excess of that protected under the Deposit Protection Scheme. The guarantee is valid until the end of 2010.

34 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\$71 million (2007: HK\$64 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.)

35 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.

35.1 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.

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

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

35.2 Investment management and control

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

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

	2008	2007
Asset type		
Bonds	75%	77%
Equities and related investments	25%	23%
	100%	100%
Currency		
US dollar and other currencies ¹	86%	88%
Euro, yen, sterling and other currencies ²	14%	12%
	100%	100%

¹ Including mainly Hong Kong dollar, Australian dollar, Canadian dollar and Singapore dollar.

² Including mainly Swiss franc, Swedish krona, Norwegian krone and Danish krone.

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.)

35.3 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.

35.3.1 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 Department of the HKMA.

Against the backdrop of a sharp deterioration in global credit markets and a surge in the volatility of financial markets during 2008, the HKMA continued to monitor market conditions closely and apply timely and effective measures to manage the Fund's credit risk exposure. As an on-going effort to strengthen the credit risk management system to be in line with best market practices, refinements have also been introduced to better the credit risk management system. The HKMA will remain vigilant in monitoring and controlling the Fund's credit risk exposure, and will sustain the impetus for better credit risk management practices to support the investment activities of the Fund.

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.)

35.3.2 Exposure to credit risk

The use of the Fund to guarantee the repayment of all customer deposits held with all authorized institutions in Hong Kong (see note 33(b)) gives rise to credit risk. However, no reliable estimate can be made of the amount that can best represent the Fund's associated maximum exposure to credit risk at the balance sheet date. The Financial Secretary does not expect that the arrangement will need to be triggered, since the Hong Kong banking sector is fundamentally sound.

The maximum exposure to credit risk arising from other financial instruments at the balance sheet date without taking account of any collateral held or other credit enhancements is shown below:

	Notes	Group		Fund	
		2008	2007	2008	2007
Cash and money at call	6	19,447	21,310	19,383	21,222
Placements with banks and other financial institutions	7	156,529	114,343	153,395	111,695
Derivative financial instruments	8(a)	9,967	3,786	7,729	3,129
Debt securities designated at fair value through profit or loss	9	1,151,283	922,882	1,151,283	922,882
Available-for-sale debt securities	10	1,210	3,256	–	–
Held-to-maturity securities	11	5,713	5,607	–	–
Loan portfolio	12	50,760	34,460	–	–
Other assets		19,549	19,664	17,792	18,329
Loan to a subsidiary	15	–	–	8,000	–
Due from a joint venture	16	2	–	–	–
Mortgage insurance risk in force	35.6	9,831	8,683	–	–
Loan commitments and other credit related commitments		88,623	89,024	110,623	99,024
Total		1,512,914	1,223,015	1,468,205	1,176,281

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.)

35.3.3 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 2008, approximately 94% (2007: 92%) 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	
	2008	2007	2008	2007
Cash and money at call, placements with banks and other financial institutions, by credit rating¹				
AAA	19,446	2,788	19,446	2,788
AA- to AA +	95,842	85,411	93,861	84,370
A- to A +	59,754	46,025	58,538	44,330
Lower than A- (including un-rated risk)	934	1,429	933	1,429
	175,976	135,653	172,778	132,917
Debt securities, by credit rating¹				
AAA	1,087,389	857,148	1,086,784	855,674
AA- to AA +	27,099	16,530	21,330	9,394
A- to A +	3,732	13,909	3,183	13,656
Lower than A- (including un-rated risk)	39,986	44,158	39,986	44,158
	1,158,206	931,745	1,151,283	922,882
Loan portfolio				
Neither past due nor impaired (note (a))	49,761	33,191	–	–
Past due but not impaired (note (b))	1,027	1,243	–	–
Impaired (note (c))	23	40	–	–
Allowance for loan impairment	(51)	(14)	–	–
	50,760	34,460	–	–
Total	1,384,942	1,101,858	1,324,061	1,055,799

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 additional to the collateral. Grade 4 includes loans with past due experience and credit enhancement in additional 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	
	2008	2007	2008	2007
Grades				
1 to 3	49,726	33,142	–	–
4	2	8	–	–
5	33	41	–	–
Total	49,761	33,191	–	–

(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	
	2008	2007	2008	2007
Loans that were past due				
90 days or less	1,021	1,226	–	–
91 – 180 days	4	12	–	–
over 180 days	2	5	–	–
Total	1,027	1,243	–	–
Fair value of collateral and other credit enhancements	2,174	2,858	–	–

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 2008, the fair value of related collateral held and credit enhancement was HK\$27 million (2007: HK\$51 million).

35.3.4 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 35.3.2) by industry groups:

	Group		Fund	
	2008	2007	2008	2007
Governments and government agencies ¹	1,127,900	881,745	1,127,556	881,399
Supra-nationals	44,674	35,901	44,576	35,794
States, provinces and public-sector entities ²	41,636	43,576	70,815	52,557
Financial institutions	172,362	149,997	164,339	140,567
Others	126,342	111,796	60,919	65,964
Total	1,512,914	1,223,015	1,468,205	1,176,281

¹ Including debt securities guaranteed by governments

² Including debt securities guaranteed by states

35.4 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.

35.4.1 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.

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

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

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.

35.4.2 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.

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

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

VaR is calculated using the parametric approach based on a 95% confidence level and one-month time horizon. The result represents the maximum expected loss of the Fund over a one-month period under normal market conditions, with a 5% chance that the actual loss may exceed the calculated VaR. The Fund's absolute VaR and the relative VaR (i.e. the VaR of the Fund relative to its investment benchmark), expressed in 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.)

35.4.3 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 – 2008							
	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	Non-interest bearing
Assets								
Cash and money at call	19,354	-	-	-	-	-	19,354	93
Placements with banks and other financial institutions	150,528	5,751	232	-	-	-	156,511	18
Financial assets designated at fair value through profit or loss	46,333	72,179	283,998	350,228	204,286	164,543	1,121,567	225,932
Available-for-sale securities	-	1,210	-	-	-	-	1,210	1,335
Held-to-maturity securities	890	406	1,455	2,568	394	-	5,713	-
Loan portfolio	34,856	15,879	14	11	-	-	50,760	-
Interest-bearing assets	251,961	95,425	285,699	352,807	204,680	164,543	1,355,115	
Liabilities								
Placements by banks and other financial institutions	9,738	3,875	-	-	-	-	13,613	-
Placements by other HKSAR government funds with interest payable at market-based rates ¹	317	-	-	-	-	-	317	-
Exchange Fund Bills and Notes issued	15,647	51,871	36,106	46,590	9,918	2,422	162,554	-
Other debt securities issued	10,079	5,244	5,792	14,941	4,519	2,211	42,786	-
Mortgage-backed securities issued	1,258	-	990	978	-	-	3,226	-
Interest-bearing liabilities	37,039	60,990	42,888	62,509	14,437	4,633	222,496	
Interest rate derivatives (net position, notional amounts)	(16,563)	(16,273)	6,172	18,524	5,238	2,902	-	
Interest rate sensitivity gap	198,359	18,162	248,983	308,822	195,481	162,812	1,132,619	

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 23). Such placements are repayable on demand and the fixed rate is determined every January. As at 31 December 2008, such placements amounted to HK\$531,053 million (2007: HK\$464,257 million).

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

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

	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	

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

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

	Fund – 2008 Repricing period							Non-interest bearing
	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	19,316	-	-	-	-	-	19,316	67
Placements with banks and other financial institutions	147,860	5,535	-	-	-	-	153,395	-
Financial assets designated at fair value through profit or loss	46,333	72,179	283,998	350,228	204,286	164,543	1,121,567	225,932
Interest-bearing assets	213,509	77,714	283,998	350,228	204,286	164,543	1,294,278	
Liabilities								
Placements by banks and other financial institutions	9,738	3,875	-	-	-	-	13,613	-
Placements by other HKSAR government funds with interest payable at market-based rates ¹	317	-	-	-	-	-	317	-
Exchange Fund Bills and Notes issued	15,647	51,871	36,106	46,590	9,918	2,422	162,554	-
Interest-bearing liabilities	25,702	55,746	36,106	46,590	9,918	2,422	176,484	
Interest rate derivatives (net position, notional amounts)	-	(7,550)	-	4,550	1,800	1,200	-	
Interest rate sensitivity gap	187,807	14,418	247,892	308,188	196,168	163,321	1,117,794	

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

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

	Fund – 2007 Repricing period							Non-interest bearing
	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.)

(b) Currency risk

The tables below summarise the currency exposure of the Group.

	Group			
	2008		2007	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
Hong Kong dollar	134.5	908.9	256.5	660.1
US dollar and other currencies ¹	1,265.9	218.2	1,038.6	179.7
	1,400.4	1,127.1	1,295.1	839.8
Euro, yen, sterling and other currencies ²	215.9	4.6	166.3	0.7
Total	1,616.3	1,131.7	1,461.4	840.5

	Fund			
	2008		2007	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
Hong Kong dollar	99.5	862.4	215.5	617.9
US dollar and other currencies ¹	1,245.5	213.2	1,032.6	178.9
	1,345.0	1,075.6	1,248.1	796.8
Euro, yen, sterling and other currencies ²	215.3	4.2	166.3	0.6
Total	1,560.3	1,079.8	1,414.4	797.4

¹ Including mainly Australian dollar, Canadian dollar and Singapore dollar.

² Including mainly Swiss franc, Swedish krona, Norwegian krone and Danish krone.

(c) Equity price risk

At 31 December 2008 and 2007, 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.)

35.4.4 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	
	2008	2007
VaR		
At 31 December	63,979	40,136
During the year		
Average	42,515	25,670
Maximum	70,987	44,450
Minimum	28,101	15,224

35.5 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.

35.5.1 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.)

35.5.2 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 – 2008						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	176,093	-	-	-	-	-	176,093
Government-issued currency notes and coins in circulation	8,266	-	-	-	-	-	8,266
Balance of the banking system	158,038	-	-	-	-	-	158,038
Placements by banks and other financial institutions	9,738	3,875	-	-	-	-	13,613
Placements by other HKSAR government funds	531,370	-	-	-	-	-	531,370
Exchange Fund Bills and Notes issued	15,647	52,342	37,704	47,732	9,397	2,083	164,905
Other debt securities issued	6,660	2,079	3,709	25,793	5,577	1,953	45,771
Mortgage-backed securities issued	13	45	1,137	2,183	-	-	3,378
Other liabilities	30,175	190	311	-	-	-	30,676
Loan commitments and other credit related commitments	88,623	-	-	-	-	-	88,623
Total	1,024,623	58,531	42,861	75,708	14,974	4,036	1,220,733

	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.)

	Fund – 2008						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	176,093	-	-	-	-	-	176,093
Government-issued currency notes and coins in circulation	8,266	-	-	-	-	-	8,266
Balance of the banking system	158,038	-	-	-	-	-	158,038
Placements by banks and other financial institutions	9,738	3,875	-	-	-	-	13,613
Placements by other HKSAR government funds	531,370	-	-	-	-	-	531,370
Exchange Fund Bills and Notes issued	15,647	52,342	37,704	47,732	9,397	2,083	164,905
Other liabilities	25,004	190	311	-	-	-	25,505
Loan commitments and other credit related commitments	110,623	-	-	-	-	-	110,623
Total	1,034,779	56,407	38,015	47,732	9,397	2,083	1,188,413

	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

35.6 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% – 30% of the value of properties financed under mortgage loans with loan-to-value ratio below 95% at origination. The Group reinsures the exposure with approved reinsurers. At 31 December 2008, the total risk-in-force was HK\$9.83 billion (2007: HK\$8.68 billion), of which HK\$5.71 billion (2007: HK\$3.51 billion) was retained by the Group after reinsurance.

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

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

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 is greater than estimated. The actual number and amount of claims and benefits will vary year to year from the estimate established using statistical techniques.

Experience shows that the larger the portfolio of similar insurance contracts, the smaller the relative variability about the expected outcome will be. In addition, a more diversified portfolio is less likely to be affected across the board by a change in any subset of the portfolio. The 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.

35.7 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. 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 guidance for 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 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.

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

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

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.

36 FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. In the absence of such quoted market prices, fair values are estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date.

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	
		2008	2007	2008	2007
Financial assets					
Held-to-maturity securities	11	5,713	5,607	5,743	5,644
Financial liabilities					
Other debt securities issued, not designated at fair value through profit or loss	25	38,073	28,320	38,079	28,324
Mortgage-backed securities issued, not designated at fair value through profit or loss	26	3,226	4,229	3,211	4,218

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 2008 and 2007.

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

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

37 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2008

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 2008 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), Presentation of Financial Statements	1 January 2009
HKAS 27 (Revised), Consolidated and Separate Financial Statements	1 July 2009
HKFRS 8, Operating Segments	1 January 2009
Amendments to HKAS 32, Financial Instruments: Presentation and HKAS 1 (Revised), Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation	1 January 2009
Amendments to HKFRS 7, Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments	1 January 2009

38 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 2009.

Calendar of Events 2008

15 January

The HKMA and the Islamic Financial Services Board jointly organise the one-and-a-half-day Seminar on Islamic Finance in Hong Kong.

5 February

The International Monetary Fund (IMF) releases its Staff Report on Hong Kong for 2007 reiterating its support for the authorities' commitment to the Linked Exchange Rate system and concluding that the real value of the Hong Kong dollar is in line with fundamentals. It also recognises the Government's efforts in furthering Hong Kong's role as an international financial centre.

20 May

The HKMA and the Dubai International Financial Centre Authority sign a Memorandum of Understanding to foster co-operation in the development of Islamic financial products and financial infrastructure.

11 July

The HKMA designates the renminbi CHATS and issues a certificate of finality to the system under the Clearing and Settlement Systems Ordinance.

17 July

The HKMA publishes the report on the review of its work on banking stability.

29 July

Supplement V to the Mainland and Hong Kong Close Economic Partnership Arrangement is signed allowing the data centres of Mainland-incorporated banking institutions of Hong Kong banks to be located in Hong Kong, subject to certain requirements.

30 September

The HKMA announces five temporary measures to provide licensed banks with collateralised liquidity, through or outside the Discount Window. These measures take effect on 2 October.

9 October

The HKMA temporarily adjusts the formula for determining the Base Rate by reducing the spread of 150 basis points above the prevailing US Federal Funds Target Rate to 50 basis points.

14 October

The Financial Secretary announces two precautionary measures, a temporary 100% deposit guarantee and the Contingent Banking Capital Facility, to strengthen public confidence in the Hong Kong banking system.

24 October

The HKMA and Bank Indonesia jointly announce the signing of a Memorandum of Understanding on the establishment of a cross-border payment-versus-payment link between Hong Kong's US dollar RTGS system and Indonesia's Rupiah RTGS system.

31 October

The HKMA announces the launch of a mediation and arbitration scheme to help resolve questions of compensation between investors in Lehman Brothers-related investment products and the distributing banks.

3 November

The operating hours of the Hong Kong dollar, US dollar, euro and renminbi RTGS systems and the Central Moneymarkets Unit were extended from 5:30 p.m. to 6:30 p.m.

6 November

The HKMA announces two refinements to the five temporary measures introduced on 2 October for providing liquidity assistance to licensed banks in Hong Kong.

11 November

In its Preliminary Conclusions, the IMF Article IV Staff Mission welcomes the Government's various measures to safeguard the stability of the financial system and maintains its long-standing support for the Linked Exchange Rate system.

21 November

The HKMA announces the arrangement with the People's Bank of China for the provision of collateralised renminbi liquidity to Hong Kong banks operating on the Mainland.

9 December

The IMF releases its Staff Report on Hong Kong for 2008 commending the Government's measures to contain the contagious risks from the global financial turmoil, reiterating its support for the Linked Exchange Rate system, and finding the real value of the Hong Kong dollar to be broadly in line with economic fundamentals.

24 December

The State Council announces a further expansion of renminbi business in Hong Kong, allowing eligible Mainland and Hong Kong enterprises to use renminbi to settle trade transactions on a trial basis.

31 December

The Hong Kong Association of Banks and the DTC Association jointly announce the launch of a revised Code of Banking Practice.

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Annex Authorized Institutions and Local Representative Offices at 31 December 2008

LICENSED BANKS

Incorporated in Hong Kong

Bank of China (Hong Kong) Limited
Bank of East Asia, Limited (The)
China Construction Bank (Asia)
Corporation Limited
Chiyu Banking Corporation Limited
Chong Hing Bank Limited
CITIBANK (HONG KONG) LIMITED
CITIC Ka Wah Bank Limited
Dah Sing Bank Limited
DBS BANK (HONG KONG) LIMITED

FUBON BANK (HONG KONG) LIMITED
Hang Seng Bank, Limited
Hongkong & Shanghai Banking
Corporation Limited (The)
Industrial and Commercial Bank of
China (Asia) Limited
MEVAS Bank Limited
Nanyang Commercial Bank, Limited
PUBLIC BANK (HONG KONG) LIMITED
Shanghai Commercial Bank Limited

Standard Bank Asia Limited
Standard Chartered Bank (Hong
Kong) Limited
Tai Sang Bank Limited
Tai Yau Bank, Limited
WING HANG BANK, LIMITED
Wing Lung Bank Limited

Incorporated outside Hong Kong

ABN AMRO Bank N.V.
Agricultural Bank of China
AIG Privat Bank AG
also known as:
AIG Private Bank Ltd
Banque Privée AIG SA
Banca Privata AIG SA
Allahabad Bank
American Express Bank Limited
Australia and New Zealand
Banking Group Limited
Axis Bank Limited
Banca Monte dei Paschi di Siena
S.p.A.
Banco Bilbao Vizcaya Argentaria S.A.
BANCO DE ORO UNIBANK, INC.
(formerly known as BANCO DE
ORO - EPCI, INC.)
BANCO SANTANDER, S.A.
Bangkok Bank Public Company
Limited
Bank of America, National Association
Bank of Baroda
Bank of China Limited

Bank of Communications Co., Ltd.
Bank of India
Bank of Montreal
BANK OF NEW YORK MELLON (THE)
(formerly known as Bank of
New York (The))
Bank of Nova Scotia (The)
Bank of Scotland plc
BANK OF TAIWAN
Bank of Tokyo-Mitsubishi UFJ, Ltd.
(The)
BANK SINOPAC
Barclays Bank PLC
Bayerische Hypo- und Vereinsbank
Aktiengesellschaft
Bayerische Landesbank
BNP PARIBAS
BNP PARIBAS WEALTH MANAGEMENT
(formerly known as BNP PARIBAS
PRIVATE BANK)
CALYON
Canadian Imperial Bank of Commerce
CANARA BANK
CATHAY BANK

CATHAY UNITED BANK COMPANY,
LIMITED
Chang Hwa Commercial Bank Ltd.
Chiba Bank, Ltd. (The)
China Construction Bank Corporation
China Merchants Bank Co., Ltd.
Chinatrust Commercial Bank, Ltd.
Chugoku Bank, Ltd. (The)
Citibank, N.A.
Commerzbank AG
Commonwealth Bank of Australia
Coöperatieve Centrale Raiffeisen-
Boerenleenbank B.A.
Credit Suisse
also known as:
Crédit Suisse
Credito Svizzero
Schweizerische Kreditanstalt
DBS BANK LTD.
DEPFA BANK plc
Deutsche Bank Aktiengesellschaft
DZ BANK AG Deutsche Zentral-
Genossenschaftsbank,
Frankfurt am Main

Annex Authorized Institutions and Local Representative Offices

at 31 December 2008 (cont.)

E.Sun Commercial Bank, Ltd.	Malayan Banking Berhad	SOCIETE GENERALE BANK & TRUST
EAST WEST BANK	MEGA INTERNATIONAL COMMERCIAL BANK CO., LTD.	Standard Chartered Bank
EFG Bank	MELLI BANK PLC	State Bank of India
ERSTE GROUP BANK AG (formerly known as Erste Bank der oesterreichischen Sparkassen AG)	Mitsubishi UFJ Trust and Banking Corporation	State Street Bank and Trust Company
FAR EASTERN INTERNATIONAL BANK	Mizuho Corporate Bank, Ltd.	Sumitomo Mitsui Banking Corporation
First Commercial Bank, Ltd.	NATIXIS	Svenska Handelsbanken AB (publ)
Fortis Bank	National Australia Bank, Limited	TAIPEI FUBON COMMERCIAL BANK CO., LTD.
Hachijuni Bank, Ltd. (The)	National Bank of Pakistan	TAISHIN INTERNATIONAL BANK CO., LTD
HANA BANK	NEWEDGE GROUP (formerly known as FIMAT INTERNATIONAL BANQUE SA)	Taiwan Business Bank
HONG LEONG BANK BERHAD	Oversea-Chinese Banking Corporation Limited	Taiwan Cooperative Bank, Ltd.
HSBC BANK INTERNATIONAL LIMITED	Philippine National Bank	Toronto-Dominion Bank
HSBC Bank plc	PT. Bank Negara Indonesia (Persero) Tbk.	UBS AG also known as: UBS SA UBS Ltd
HSBC Bank USA, National Association	Public Bank Berhad	UCO Bank
HSBC Private Bank (Suisse) SA	Punjab National Bank	UNICREDIT, SOCIETA' PER AZIONI (formerly known as UniCredito Italiano Societa' per Azioni)
HSH Nordbank AG	RBS Coutts Bank AG also known as: RBS Coutts Bank SA RBS Coutts Bank Ltd (formerly known as Coutts Bank von Ernst AG also known as: Coutts Bank von Ernst SA Coutts Bank von Ernst Ltd)	Union Bank of India
Hua Nan Commercial Bank, Ltd.	Royal Bank of Canada	UNITED COMMERCIAL BANK
ICICI BANK LIMITED	Royal Bank of Scotland public limited company (The)	United Overseas Bank Ltd.
Indian Overseas Bank	Shanghai Commercial & Savings Bank, Ltd. (The)	Wells Fargo Bank, National Association
Industrial and Commercial Bank of China Limited	Shiga Bank, Ltd. (The)	WestLB AG
Industrial Bank of Korea #	Shinhan Bank #	Westpac Banking Corporation
Industrial Bank of Taiwan Co., Ltd. #	Shinkin Central Bank	Woori Bank
ING ASIA PRIVATE BANK LTD #	Shizuoka Bank, Ltd. (The)	
ING Bank N.V.	Societe Generale	
INTESA SANPAOLO SPA		
Iyo Bank, Ltd. (The)		
JPMorgan Chase Bank, National Association		
KBC Bank N.V.		
Korea Exchange Bank		
Land Bank of Taiwan Co., Ltd.		

Deletion in 2008

UNICREDIT BANCA DI ROMA, S.P.A.
(formerly known as
BANCA DI ROMA, SOCIETA' PER
AZIONI)

Addition in 2008

Annex Authorized Institutions and Local Representative Offices at 31 December 2008 (cont.)

RESTRICTED LICENCE BANKS

Incorporated in Hong Kong

AIG Finance (Hong Kong) Limited
 ALLIED BANKING CORPORATION
 (HONG KONG) LIMITED
 Banc of America Securities Asia
 Limited
 BOCI Capital Limited
 Citicorp International Limited
 GE Capital (Hong Kong) Limited
 Indover bank (Asia) Limited

J.P. MORGAN SECURITIES (ASIA
 PACIFIC) LIMITED
 KDB Asia Limited
 KOOKMIN BANK HONG KONG
 LIMITED
 Mitsubishi UFJ Securities (HK)
 Capital, Limited
 ORIX Asia Limited
 SCOTIABANK (HONG KONG) LIMITED

Societe Generale Asia Limited
 UBAF (Hong Kong) Limited

Deletion in 2008

ICBC International Holdings Limited
 (formerly known as
 Industrial and Commercial
 International Capital Limited)

Incorporated outside Hong Kong

Bank of Ayudhya Public Company
 Limited
 CIMB BANK BERHAD
 Credit Agricole (Suisse) SA
 EUROCLEAR BANK #
 Lloyds TSB Bank Plc
 Mashreq Bank - Public Shareholding
 Company
 also known as:
 Mashreqbank psc

PT. BANK MANDIRI (PERSERO) Tbk
 RBC Dexia Investor Services Bank S.A.
 Siam Commercial Bank Public
 Company Limited (The)
 Thanakharn Kasikorn Thai Chamkat
 (Mahachon)
 also known as:
 KASIKORNBANK PUBLIC
 COMPANY LIMITED

TMB Bank Public Company Limited
 Wachovia Bank, National Association

Deletion in 2008

Industrial Bank of Korea (upgraded to
 a Licensed bank)
 Shinhan Bank (upgraded to a
 Licensed bank)

Addition in 2008

Annex Authorized Institutions and Local Representative Offices

at 31 December 2008 (cont.)

DEPOSIT-TAKING COMPANIES

Incorporated in Hong Kong

AGRO ENTERPRISES COMPANY LIMITED	Gunma Finance (Hong Kong) Limited	PrimeCredit Limited
BCOM Finance (Hong Kong) Limited	Habib Finance International Limited	PUBLIC FINANCE LIMITED
BPI International Finance Limited	Hachijuni Asia Limited	SHINHAN ASIA LIMITED
Chau's Brothers Finance Company Limited	HBZ Finance Limited	Sumitomo Trust Finance (H.K.) Limited (The)
Chong Hing Finance Limited	Henderson International Finance Limited	Vietnam Finance Company Limited
Commonwealth Finance Corporation Limited	HKCB Finance Limited	Wing Hang Finance Company Limited
Corporate Finance (D.T.C.) Limited	Hung Kai Finance Company Limited	Wing Lung Finance Limited
First Metro International Investment Company Limited	Inchroy Credit Corporation Limited	WOORI GLOBAL MARKETS ASIA LIMITED
FUBON CREDIT (HONG KONG) LIMITED	KEXIM ASIA LIMITED	
	OCTOPUS CARDS LIMITED	
	Orient First Capital Limited	
		Deletion in 2008
		Delta Asia Credit Limited

Incorporated outside Hong Kong

NIL

Annex Authorized Institutions and Local Representative Offices

at 31 December 2008 (cont.)

LOCAL REPRESENTATIVE OFFICES

ANTWERPSE DIAMANTBANK NV also known as: ANTWERP DIAMOND BANK NV	China Everbright Bank Co., Ltd	Raiffeisen Zentralbank Osterreich AG
Arab Bank plc	CHINA MINSHENG BANKING CORPORATION LIMITED	Resona Bank, Limited
BANCA POPOLARE COMMERCIO E INDUSTRIA SPA	CLEARSTREAM BANKING S.A.	Rothschild Bank AG
Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l.	Corporation Bank #	Schroder & Co Bank AG also known as: Schroder & Co Banque SA Schroder & Co Banca SA Schroder & Co Bank Ltd Schroder & Co Banco SA
Banca Popolare di Ancona Societa' per azioni	Credit Industriel et Commercial	Shanghai Pudong Development Bank Co., Ltd.
Banca Popolare di Bergamo S.p.A.	Credito Bergamasco S.p.A.	Shenzhen Development Bank Co., Ltd.
Banca Popolare di Novara - Societa' per Azioni	D.A.H. Hambros Bank (Channel Islands) Limited	Shoko Chukin Bank, Ltd. (The) [formerly known as Shoko Chukin Bank (The)]
Banca Popolare di Sondrio Soc. Coop. a r.l.	Eurohypo Aktiengesellschaft	Union Bank of Taiwan
BANCA POPOLARE DI VICENZA - Società cooperativa per azioni	Fiduciary Trust Company International	Unione di Banche Italiane Società Cooperativa per Azioni
Banco de Crédito e Inversiones	GUANGDONG DEVELOPMENT BANK CO., LTD.	Veneto Banca S.c.a.r.l.
Banco do Brasil S.A.	Habib Bank A.G. Zurich	Verwaltungs- und Privat-Bank Aktiengesellschaft
Banco Popolare- Societa' Cooperativa	HSBC Bank Canada	Yamaguchi Bank, Ltd. (The)
Banco Popular Español, S.A.	HSBC Guyerzeller Bank AG	Yamanashi Chuo Bank, Ltd.
Bank Hapoalim (Switzerland) Ltd	HSBC Trinkaus & Burkhardt (International) S.A.	Yuanta Commercial Bank Co., Ltd
Bank Julius Baer & Co. Ltd.	Investec Bank Limited	
Bank Leumi Le-Israel B.M.	Juroku Bank, Ltd. (The)	
BANK OF BEIJING CO., LTD. #	Korea Development Bank (The)	
Bank of Fukuoka, Ltd. (The)	Landsbanki Íslands hf	
Bank of Kyoto, Ltd. (The)	LGT Bank in Liechtenstein AG also known as: LGT Bank in Liechtenstein Ltd. LGT Banque de Liechtenstein S.A. LGT Banca di Liechtenstein S.A.	
BANK OF SCOTLAND INTERNATIONAL LIMITED	LLOYDS TSB OFFSHORE LIMITED	Deletion in 2008
Bank of Yokohama, Ltd. (The)	Merrill Lynch Bank (Suisse) S.A.	Banca del Gottardo
Banque Piguet & Cie SA	Metropolitan Bank and Trust Company	CITIC Group
Banque Privee Edmond de Rothschild S.A.	Nanto Bank, Ltd. (The)	DePfa Investment Bank Limited
BARCLAYS BANK (SUISSE) S.A.	National Bank of Canada	DVB Bank N.V.
BSI LTD	Nishi-Nippon Bank, Ltd. (The)	eBANK Corporation
CARIPRATO - Cassa di Risparmio di Prato S.p.A.	Norinchukin Bank (The)	EUROCLEAR BANK
China Development Bank	Ogaki Kyoritsu Bank, Ltd. (The)	Japan Bank for International Cooperation
	Oita Bank, Ltd. (The)	Kredietbank S.A. Luxembourgeoise
	P.T. Bank Central Asia	Standard Bank of South Africa Ltd. (The)
	P.T. Bank Rakyat Indonesia (Persero)	STANDARD CHARTERED (JERSEY) LIMITED

Addition in 2008

Table A Major Economic Indicators

	2004	2005	2006	2007	2008
I. Gross Domestic Product					
Real GDP growth (%)	8.5	7.1	7.0	6.4	2.5 ^(a)
Nominal GDP growth (%)	4.6	7.0	6.7	9.5	3.9 ^(a)
Real growth of major expenditure components of GDP (%)					
– Private consumption expenditure	7.0	3.0	5.9	8.5	1.8 ^(a)
– Government consumption expenditure	0.7	(3.2)	0.3	3.0	2.0 ^(a)
– Gross domestic fixed capital formation	2.5	4.1	7.1	3.4	(0.3) ^(a)
of which					
– Building and construction	(10.7)	(7.6)	(7.1)	(0.2)	0.3 ^(a)
– Machinery, equipment and computer software	10.3	12.8	19.2	3.0	0.6 ^(a)
– Exports	15.4	10.6	9.4	8.3	2.7 ^(a)
– Imports	13.8	8.0	9.1	9.1	2.1 ^(a)
GDP at current market prices (US\$ billion)	165.9	177.8	189.9	207.0	215.6 ^(a)
Per capita GDP at current market prices (US\$)	24,454	26,094	27,697	29,891	30,893 ^(a)
II. External Trade (HK\$ billion)					
Merchandise trade ^(b)					
– Domestic exports of goods	126.4	136.3	138.8	117.2	101.7 ^(a)
– Re-exports of goods	1,900.6	2,115.4	2,328.6	2,581.7	2,742.3 ^(a)
– Total imports of goods	2,099.5	2,311.1	2,576.3	2,852.5	3,024.1 ^(a)
– Merchandise trade balance	(72.5)	(59.3)	(109.0)	(153.7)	(180.1) ^(a)
Services trade					
– Exports of services	429.6	495.4	565.1	660.7	719.9 ^(a)
– Imports of services	242.5	264.2	287.9	332.2	357.3 ^(a)
– Services trade balance	187.1	231.2	277.2	328.5	362.6 ^(a)
III. Fiscal Expenditure and Revenue (HK\$ million, fiscal year)					
Total government expenditure	242,235	233,071	229,413	234,815	317,766 ^(a)
Total government revenue	263,591	247,035	288,014	358,465	312,885 ^(a)
Consolidated surplus/deficit	21,356	13,964	58,601	123,650	(4,881) ^(a)
Reserve balance as at end of fiscal year ^(c)	295,981	310,663	369,264	492,914	488,033 ^(a)
IV. Prices (annual change, %)					
Consumer Price Index (A)	0.0	1.1	1.7	1.3	3.6
Composite Consumer Price Index	(0.4)	1.0	2.0	2.0	4.3
Trade Unit Value Indices					
– Domestic exports	1.5	2.2	(2.1)	0.8	5.1
– Re-exports	1.1	1.2	1.1	2.4	3.8
– Imports	2.9	2.7	2.1	2.3	4.4
Property Price Indices					
– Residential flats	26.6	17.9	0.8	11.7	16.4 ^(a)
– Office premises	58.9	33.9	4.7	18.8	20.3 ^(a)
– Retail premises	39.5	25.1	2.8	12.4	11.4 ^(a)
– Flatted factory premises	23.6	41.1	26.8	25.9	18.1 ^(a)

Table A Major Economic Indicators (cont.)

	2004	2005	2006	2007	2008
V. Labour					
Labour force (annual change, %)	1.4	0.6	1.1	1.6	0.5
Employment (annual change, %)	2.6	1.9	1.9	2.4	1.0
Unemployment rate (annual average, %)	6.8	5.6	4.8	4.0	3.6
Underemployment rate (annual average, %)	3.3	2.7	2.4	2.2	1.9
Employment ('000)	3,274	3,337	3,401	3,484	3,519
of which					
– Manufacturing	232	224	217	202	191
– Financing, insurance, real estate and business services	480	503	526	548	580
– Wholesale, retail and import/export trades, restaurants and hotels	1,062	1,094	1,105	1,144	1,146
VI. Money Supply (HK\$ billion)					
HK\$ money supply					
– M1	412.6	348.2	387.9	454.3	491.1 ^(a)
– M2 ^(d)	2,208.6	2,329.7	2,777.7	3,281.0	3,239.9 ^(a)
– M3 ^(d)	2,219.6	2,345.8	2,795.5	3,300.5	3,261.4 ^(a)
Total money supply					
– M1	484.5	434.7	491.6	616.7	645.8 ^(a)
– M2	4,166.7	4,379.1	5,054.3	6,106.3	6,269.8 ^(a)
– M3	4,189.5	4,407.2	5,089.7	6,139.8	6,302.5 ^(a)
VII. Interest Rates (end of period, %)					
Three-month interbank rate	0.28	4.16	3.84	3.31	0.89
Savings deposit	0.01	2.32	2.26	1.26	0.01
One-month time deposit	0.02	2.68	2.52	1.61	0.04
Banks' 'Best lending rate'	5.00	7.75	7.75	6.75	5.00
Banks' 'Composite rate'	0.30	2.88	2.86	2.29	0.68
VIII. Exchange Rates (end of period)					
HK\$/US\$	7.774	7.753	7.775	7.802	7.751
Trade-weighted Effective Exchange Rate Index (Jan 2000 = 100)	96.0	98.4	94.3	88.6	88.3
IX. Foreign Currency Reserve Assets (US\$ billion) ^(e)	123.6	124.3	133.2	152.7	182.5
X. Stock Market (end of period figures)					
Hang Seng Index	14,230	14,876	19,965	27,813	14,387
Average price/earning ratio	18.7	15.6	17.4	22.5	7.3
Market capitalisation (HK\$ billion)	6,629.2	8,113.3	13,248.8	20,536.5	10,253.6

(a) The estimates are preliminary.

(b) Includes non-monetary gold.

(c) Includes changes in provision for loss in investments with the Exchange Fund.

(d) Adjusted to include foreign currency swap deposits.

(e) Exclude unsettled forward transactions but include gold.

Table B Performance Ratios of the Banking Sector ^(a)

	2004 %	2005 %	All AIs 2006 %	2007 %	2008 %
Asset Quality ^(b)					
As % of total credit exposures ^(c)					
Total outstanding provisions/impairment allowances	0.78	0.49	0.38	0.35	0.68
Classified ^(d) exposures:					
Gross	1.22	0.81	0.59	0.48	0.84
Net of specific provisions/individual impairment allowances	0.81	0.54	0.41	0.32	0.38
Net of all provisions/impairment allowances	0.44	0.33	0.21	0.13	0.16
As % of total loans					
Total outstanding provisions/impairment allowances	1.42	0.87	0.71	0.59	0.88
Classified ^(d) loans:					
Gross	2.11	1.34	1.05	0.75	1.23
Net of specific provisions/individual impairment allowances	1.40	0.87	0.73	0.52	0.75
Net of all provisions/impairment allowances	0.70	0.47	0.34	0.16	0.35
Overdue > 3 months and rescheduled loans	1.54	0.94	0.76	0.51	0.69
Profitability					
Return on assets (operating profit)	1.06	1.07	1.13	1.37	0.57
Return on assets (post-tax profit)	0.97	0.97	1.01	1.21	0.47
Net interest margin	1.18	1.18	1.29	1.32	1.30
Cost-to-income ratio	48.7	50.4	50.8	46.7	55.6
Bad debt charge to total assets	0.01	0.01	0.03	0.04	0.18
Liquidity					
Loan to deposit ratio (all currencies)	55.8	56.8	51.9	50.5	54.2
Loan to deposit ^(e) ratio (Hong Kong dollar)	82.6	84.3	74.7	71.0	77.6

Asset Quality

Delinquency ratio of residential mortgage loans
Credit card receivables
Delinquency ratio
Charge-off ratio

Profitability

Operating profit to shareholders' funds
Post-tax profit to shareholders' funds

Capital Adequacy

Equity to assets ratio ^(b)

Capital Adequacy Ratio (Consolidated) ^(f)

(a) Figures are related to Hong Kong office(s) only unless otherwise stated.

(b) Figures are related to Hong Kong office(s). For the locally incorporated AIs, figures include their overseas branches.

(c) Credit exposures include loans and advances, acceptances and bills of exchange held, investment debt securities issued by others, accrued interest, and commitments and contingent liabilities to or on behalf of non-banks.

(d) Denotes loans or exposures graded as "substandard", "doubtful" or "loss" in the HKMA's Loan Classification System.

(e) Includes swap deposits.

(f) From 1 January 2007, all locally incorporated AIs started to report their capital adequacy positions according to the Banking (Capital) Rules (i.e. the Basel II framework).

Retail Banks				
2004 %	2005 %	2006 %	2007 %	2008 %
0.77	0.42	0.33	0.33	0.67
1.27	0.82	0.63	0.54	0.87
0.91	0.60	0.48	0.38	0.40
0.50	0.39	0.30	0.21	0.20
1.45	0.78	0.63	0.55	0.79
2.25	1.37	1.11	0.85	1.24
1.59	0.98	0.85	0.65	0.84
0.80	0.59	0.48	0.30	0.46
1.48	0.92	0.80	0.57	0.68
1.52	1.55	1.53	1.66	0.99
1.39	1.40	1.36	1.48	0.85
1.66	1.68	1.80	1.90	1.84
41.4	41.8	42.8	40.5	45.1
-0.02	-0.01	0.01	0.04	0.18
50.0	53.2	47.9	45.5	47.2
73.2	78.8	69.1	65.1	69.4
Surveyed Institutions				
2004 %	2005 %	2006 %	2007 %	2008 %
0.38	0.19	0.20	0.11	0.05
0.44	0.37	0.37	0.35	0.34
4.73	2.81	2.91	2.90	2.72
Locally Incorporated Banks				
2004 %	2005 %	2006 %	2007 %	2008 %
18.7	18.4	18.9	23.8	14.7
17.2	16.7	16.7	21.3	12.6
10.6	8.1	8.2	8.2	7.3
All Locally Incorporated AIs				
2004 %	2005 %	2006 %	2007 %	2008 %
15.4	14.8	14.9	13.4	14.8

Table C Authorized Institutions: Domicile and Parentage

	2004	2005	2006	2007	2008
Licensed Banks					
(i) Incorporated in Hong Kong	24	24	24	23	23
(ii) Incorporated outside Hong Kong	109	109	114	119	122
Total	133	133	138	142	145
Restricted Licence Banks					
(i) Subsidiaries of licensed banks :					
(a) incorporated in Hong Kong	1	0	0	0	0
(b) incorporated outside Hong Kong	10	8	8	8	6
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	23	21	20	18	17
(iii) Bank related	3	1	0	0	0
(iv) Others	3	3	3	3	4
Total	40	33	31	29	27
Deposit-taking Companies					
(i) Subsidiaries of licensed banks :					
(a) incorporated in Hong Kong	7	6	5	5	7
(b) incorporated outside Hong Kong	2	2	3	3	3
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	14	13	13	10	8
(iii) Bank related	2	3	3	3	2
(iv) Others	10	9	9	8	8
Total	35	33	33	29	28
All Authorized Institutions	208	199	202	200	200
Local Representative Offices	85	86	84	79	71

Table D Authorized Institutions: Region/Economy of Beneficial Ownership

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	04	05	06	07	08	04	05	06	07	08	04	05	06	07	08
Asia and Pacific															
Hong Kong	12	12	11	11	10	1	1	–	–	–	12	11	10	10	9
Australia	4	4	4	4	4	–	–	–	–	–	–	–	–	–	–
Mainland China	13	12	13	12	13	2	2	2	2	1	2	2	2	2	3
India	4	5	9	11	11	1	1	1	–	–	2	2	2	1	1
Indonesia	1	1	1	1	1	2	2	2	2	2	1	1	1	–	–
Japan	12	12	11	11	11	4	3	2	2	2	4	4	4	3	3
Malaysia	3	3	4	4	4	1	1	1	1	1	1	1	1	1	1
Pakistan	1	1	1	1	1	–	–	–	–	–	2	2	2	2	2
Philippines	2	2	2	2	2	1	1	1	1	1	3	3	3	3	3
Singapore	4	4	4	4	4	–	–	–	–	–	–	–	–	–	–
South Korea	3	3	3	3	5	4	4	5	4	2	2	2	3	3	3
Taiwan	14	15	15	17	18	–	–	–	–	–	1	1	1	1	1
Thailand	1	1	1	1	1	4	4	4	4	4	–	–	–	–	–
Vietnam	–	–	–	–	–	–	–	–	–	–	1	1	1	1	1
Sub-total	74	75	79	82	85	20	19	18	16	13	31	30	30	27	27
Europe															
Austria	1	1	1	1	1	–	–	–	–	–	–	–	–	–	–
Belgium	2	2	2	2	2	–	–	–	–	1	–	–	–	–	–
Denmark	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
France	6	5	7	7	7	2	2	3	3	3	–	–	–	–	–
Germany	8	8	7	8	7	1	1	–	–	–	–	–	–	–	–
Italy	6	6	6	4	4	–	–	–	–	–	–	–	–	–	–
Netherlands	3	3	3	3	4	–	–	–	–	–	–	–	–	–	–
Spain	1	1	1	2	2	–	–	–	–	–	–	–	–	–	–
Sweden	1	1	1	1	1	–	–	–	–	–	–	–	–	–	–
Switzerland	3	3	3	3	3	1	–	–	–	–	–	–	–	–	–
United Kingdom	10	10	10	10	11	1	1	1	1	1	–	–	–	–	–
Sub-total	41	40	41	41	42	5	4	4	4	5	–	–	–	–	–
Middle East															
Bahrain	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Iran	1	2	1	1	1	–	–	–	–	–	–	–	–	–	–
United Arab Emirates	–	–	–	–	–	1	1	1	1	1	–	–	–	–	–
Sub-total	1	2	1	1	1	1	1	1	1	1	–	–	–	–	–
North America															
Canada	5	5	5	5	5	2	1	1	1	1	–	–	–	–	–
United States	11	10	11	12	11	8	6	6	6	6	3	2	2	1	1
Sub-total	16	15	16	17	16	10	7	7	7	7	3	2	2	1	1
South Africa	1	1	1	1	1	2	1	–	–	–	–	–	–	–	–
Bermuda	–	–	–	–	–	1	–	–	–	–	–	–	–	–	–
Others	–	–	–	–	–	1	1	1	1	1	1	1	1	1	–
Grand Total	133	133	138	142	145	40	33	31	29	27	35	33	33	29	28

Table E Presence of World's Largest 500 Banks in Hong Kong

Positions at 31 December 2008	Number of Overseas Banks ^(b)					Licensed Banks ^(c)				
	04	05	06	07	08	04	05	06	07	08
World Ranking ^(a)										
1-20	20	19	20	20	20	33	28	33	33	35
21-50	22	25	23	22	23	19	25	23	22	22
51-100	28	27	26	26	26	23	23	21	19	23
101-200	42	39	37	38	35	22	19	20	25	21
201-500	45	47	50	46	55	17	22	25	23	27
Sub-total	157	157	156	152	159	114	117	122	122	128
Others	52	51	55	59	46	19	16	16	20	17
Total	209	208	211	211	205	133	133	138	142	145

(a) Top 500 banks/banking groups in the world ranked by total assets. Figures are extracted from *The Banker*, July 2008 issue.

(b) The sum of the number of licensed banks, restricted licence banks, deposit-taking companies and local representative offices exceeds the number of overseas banks with presence in Hong Kong due to the multiple presence of some of the overseas banks.

(c) Consist of branches and subsidiaries of overseas banks.

Restricted Licence Banks ^(c)					Deposit-taking Companies ^(c)					Local Representative Offices				
04	05	06	07	08	04	05	06	07	08	04	05	06	07	08
10	5	5	7	6	1	1	1	-	-	7	8	8	6	6
5	5	5	5	5	-	-	-	-	-	4	5	5	5	5
4	4	4	2	1	2	3	5	5	6	5	5	7	9	3
3	2	1	1	1	4	3	3	3	2	22	21	19	15	14
7	5	5	6	8	5	3	3	1	1	20	21	22	19	22
29	21	20	21	21	12	10	12	9	9	58	60	61	54	50
11	12	11	8	6	23	23	21	20	19	27	26	23	25	21
40	33	31	29	27	35	33	33	29	28	85	86	84	79	71

Table F Balance Sheet: All Authorized Institutions and Retail Banks

All Authorized Institutions (HK\$ bn)	2004			2005		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	1,667	489	2,156	1,797	515	2,312
Inside Hong Kong ^(a)	1,631	291	1,923	1,749	323	2,072
Outside Hong Kong ^(b)	36	198	233	48	192	240
Interbank lending	447	2,577	3,024	433	2,457	2,890
Inside Hong Kong	291	185	476	227	182	410
Outside Hong Kong	156	2,392	2,548	206	2,275	2,481
Negotiable certificates of deposit (NCD)	74	48	121	66	32	97
Negotiable debt instruments, other than NCD	459	870	1,328	437	934	1,371
Other assets	296	212	508	314	263	577
Total Assets	2,943	4,195	7,138	3,047	4,200	7,247
Liabilities						
Deposits from customers ^(c)	2,018	1,848	3,866	2,132	1,936	4,068
Interbank borrowing	439	1,711	2,150	412	1,555	1,967
Inside Hong Kong	296	203	499	231	184	416
Outside Hong Kong	143	1,508	1,651	180	1,371	1,551
Negotiable certificates of deposit	124	132	256	131	132	263
Other liabilities	609	256	865	624	325	949
Total Liabilities	3,191	3,947	7,138	3,299	3,948	7,247

Retail Banks (HK\$ bn)	2004			2005		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	1,371	200	1,571	1,510	215	1,725
Inside Hong Kong ^(a)	1,354	159	1,513	1,483	160	1,643
Outside Hong Kong ^(b)	17	41	58	27	56	83
Interbank lending	302	1,022	1,324	266	982	1,247
Inside Hong Kong	235	117	352	175	101	276
Outside Hong Kong	67	905	972	91	881	972
Negotiable certificates of deposit (NCD)	55	28	83	50	20	71
Negotiable debt instruments, other than NCD	317	583	900	316	640	955
Other assets	244	99	343	241	121	362
Total Assets	2,289	1,932	4,220	2,383	1,978	4,361
Liabilities						
Deposits from customers ^(c)	1,874	1,270	3,144	1,916	1,326	3,242
Interbank borrowing	89	295	384	102	264	366
Inside Hong Kong	38	30	68	58	38	95
Outside Hong Kong	51	265	316	45	226	271
Negotiable certificates of deposit	80	99	179	85	97	182
Other liabilities	434	79	513	462	109	571
Total Liabilities	2,477	1,743	4,220	2,565	1,796	4,361

(a) Defined as loans for use in Hong Kong plus trade finance.

(b) Include "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

2006			2007			2008		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,917	550	2,468	2,185	777	2,962	2,355	929	3,284
1,832	294	2,126	2,057	400	2,457	2,201	509	2,710
86	256	342	128	377	504	154	420	574
647	2,802	3,449	797	3,714	4,510	542	3,484	4,026
304	198	502	346	269	615	261	287	548
343	2,604	2,947	451	3,444	3,895	281	3,197	3,478
60	43	103	66	28	93	39	49	88
536	1,081	1,617	499	1,190	1,688	392	1,434	1,825
347	323	670	529	567	1,096	604	901	1,505
3,507	4,799	8,306	4,075	6,275	10,350	3,932	6,797	10,729
2,568	2,189	4,757	3,075	2,794	5,869	3,034	3,026	6,060
518	1,739	2,257	605	2,357	2,961	444	2,496	2,940
309	203	511	353	277	630	259	292	551
210	1,536	1,746	251	2,080	2,331	185	2,204	2,389
129	110	240	122	49	172	86	22	108
678	374	1,052	852	497	1,348	781	841	1,622
3,894	4,412	8,306	4,653	5,697	10,350	4,345	6,384	10,729
2006			2007			2008		
HK\$	F/CY	Total	HK\$	F/CY	Total	HK\$	F/CY	Total
1,577	218	1,794	1,742	279	2,021	1,870	365	2,234
1,528	148	1,676	1,675	190	1,865	1,787	258	2,045
48	70	118	67	89	156	83	107	190
425	1,023	1,449	470	1,367	1,837	368	1,205	1,573
245	103	348	269	155	424	200	172	372
180	920	1,100	201	1,211	1,413	168	1,034	1,201
44	16	59	47	13	60	27	25	52
422	755	1,177	378	778	1,156	293	1,076	1,369
279	165	444	391	328	719	457	578	1,035
2,747	2,177	4,924	3,029	2,764	5,793	3,014	3,250	6,264
2,283	1,466	3,749	2,674	1,763	4,437	2,695	2,036	4,731
116	228	344	138	297	435	115	356	471
51	35	86	69	44	114	49	72	121
65	193	258	69	253	322	66	284	350
76	83	159	67	37	104	40	13	53
537	136	673	641	176	817	568	441	1,009
3,011	1,913	4,924	3,519	2,274	5,793	3,418	2,846	6,264

Table G Major Balance Sheet Items by Region/Economy of Beneficial Ownership of Authorized Institutions

(HK\$ bn)		Mainland China	Japan	US	Europe	Others	Total
Total Assets	2007	1,632	603	909	3,039	4,167	10,350
	2008	1,859	718	789	3,019	4,345	10,729
Deposits from Customers	2007	1,191	179	465	1,107	2,928	5,869
	2008	1,318	187	395	1,152	3,007	6,060
Loans to Customers	2007	704	174	135	602	1,347	2,962
	2008	836	208	130	647	1,463	3,284
Loans to Customers Inside Hong Kong ^(a)	2007	577	133	121	414	1,212	2,457
	2008	672	156	120	451	1,311	2,710
Loans to Customers Outside Hong Kong ^(b)	2007	127	42	13	188	135	504
	2008	164	52	10	196	152	574

(a) Defined as loans for use in Hong Kong plus trade finance.

(b) Include "others" (i.e. unallocated).

Figures may not add up to total due to rounding.

Table H Flow of Funds for All Authorized Institutions and Retail Banks

All Authorized Institutions						
(HK\$ bn)						
Increase/(Decrease) in	2007			2008		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	267	227	494	170	152	323
Inside Hong Kong ^(a)	225	106	331	144	109	253
Outside Hong Kong ^(b)	42	121	163	26	44	70
Interbank lending	150	912	1,062	(254)	(230)	(484)
Inside Hong Kong	42	71	113	(85)	18	(67)
Outside Hong Kong	108	840	948	(170)	(247)	(417)
All other assets	151	338	489	(58)	599	541
Total Assets	568	1,476	2,044	(143)	522	379
Liabilities						
Deposits from customers ^(c)	507	605	1,112	(41)	232	191
Interbank borrowing	86	618	704	(161)	140	(21)
Inside Hong Kong	44	74	118	(94)	16	(79)
Outside Hong Kong	42	544	586	(66)	124	58
All other liabilities	167	62	228	(106)	316	210
Total Liabilities	760	1,285	2,044	(308)	688	379
Net Interbank Borrowing/(Lending)	(64)	(294)	(357)	93	369	463
Net Customer Lending/(Borrowing)	(239)	(378)	(618)	211	(79)	132

Retail Banks						
(HK\$ bn)						
Increase/(Decrease) in	2007			2008		
	HK\$	F/CY	Total	HK\$	F/CY	Total
Assets						
Loans to customers	165	61	226	128	86	214
Inside Hong Kong ^(a)	147	42	189	112	68	180
Outside Hong Kong ^(b)	19	19	37	16	18	34
Interbank lending	45	343	388	(102)	(161)	(264)
Inside Hong Kong	24	52	76	(69)	16	(52)
Outside Hong Kong	21	291	312	(34)	(178)	(211)
All other assets	71	183	254	(40)	561	521
Total Assets	281	587	869	(14)	485	471
Liabilities						
Deposits from customers ^(c)	391	297	688	22	273	294
Interbank borrowing	22	69	92	(23)	59	35
Inside Hong Kong	18	10	28	(20)	27	7
Outside Hong Kong	4	60	64	(3)	31	28
All other liabilities	95	(6)	89	(99)	241	141
Total Liabilities	508	361	869	(101)	572	471
Net Interbank Borrowing/(Lending)	(23)	(274)	(297)	79	220	299
Net Customer Lending/(Borrowing)	(226)	(236)	(462)	107	(187)	(81)

(a) Defined as loans for use in Hong Kong plus trade finance.

(b) Include "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

Table I Loans to and Deposits from Customers by Category of Authorized Institutions

(HK\$ bn)	Loans to Customers				Deposits from Customers ^(a)			
	HK\$	F/CY	Total	%	HK\$	F/CY	Total	%
2004								
Licensed banks	1,581	475	2,057	95	2,007	1,839	3,846	99
Restricted licence banks	67	12	79	4	8	7	15	–
Deposit-taking companies	19	2	21	1	3	2	5	–
Total	1,667	489	2,156	100	2,018	1,848	3,866	100
2005								
Licensed banks	1,750	500	2,250	97	2,116	1,927	4,043	99
Restricted licence banks	26	13	39	2	12	7	19	–
Deposit-taking companies	22	1	23	1	3	2	5	–
Total	1,797	515	2,312	100	2,132	1,936	4,068	100
2006								
Licensed banks	1,870	532	2,402	97	2,551	2,174	4,725	99
Restricted licence banks	24	17	41	2	14	13	26	1
Deposit-taking companies	23	1	24	1	3	2	5	–
Total	1,917	550	2,468	100	2,568	2,189	4,757	100
2007								
Licensed banks	2,127	749	2,876	97	3,056	2,782	5,839	99
Restricted licence banks	32	26	59	2	15	9	25	–
Deposit-taking companies	25	2	27	1	3	2	5	–
Total	2,185	777	2,962	100	3,075	2,794	5,869	100
2008								
Licensed banks	2,293	902	3,196	97	3,014	3,015	6,028	99
Restricted licence banks	35	24	59	2	15	9	24	–
Deposit-taking companies	27	3	29	1	6	2	8	–
Total	2,355	929	3,284	100	3,034	3,026	6,060	100

(a) Hong Kong dollar customer deposits include swap deposits.

A “–” sign denotes a figure of less than 0.5.

Figures may not add up to total due to rounding.

Table J Loans to Customers Inside Hong Kong by Economic Sector

All Authorized Institutions										
(HK\$ bn)										
Sector	2004		2005		2006		2007		2008	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	130	7	142	7	152	7	183	7	186	7
Manufacturing	99	5	119	6	103	5	121	5	147	5
Transport and transport equipment	121	6	123	6	123	6	145	6	155	6
Building, construction and property development, and investment	386	20	451	22	492	23	578	24	687	25
Wholesale and retail trade	99	5	101	5	105	5	116	5	152	6
Financial concerns (other than authorized institutions)	168	9	179	9	185	9	251	10	283	10
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	77	4	68	3	60	3	58	2	57	2
to purchase other residential properties	534	28	539	26	535	25	564	23	593	22
other purposes	149	8	169	8	182	9	221	9	226	8
Others	158	8	183	9	188	9	220	9	223	8
Total ^(a)	1,923	100	2,072	100	2,126	100	2,457	100	2,710	100

Retail Banks										
(HK\$ bn)										
Sector	2004		2005		2006		2007		2008	
	HK\$	%	HK\$	%	HK\$	%	HK\$	%	HK\$	%
Hong Kong's visible trade	103	7	115	7	124	7	147	8	147	7
Manufacturing	65	4	75	5	68	4	79	4	98	5
Transport and transport equipment	76	5	81	5	82	5	87	5	92	4
Building, construction and property development, and investment	331	22	378	23	397	24	460	25	536	26
Wholesale and retail trade	67	4	69	4	73	4	78	4	99	5
Financial concerns (other than authorized institutions)	65	4	70	4	76	5	88	5	106	5
Individuals:										
to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	51	3	68	4	60	4	58	3	57	3
to purchase other residential properties	515	34	526	32	522	31	551	30	579	28
other purposes	126	8	140	9	152	9	178	10	188	9
Others	113	7	120	7	123	7	139	7	144	7
Total ^(a)	1,513	100	1,643	100	1,676	100	1,865	100	2,045	100

(a) Defined as loans for use in Hong Kong plus trade finance.

Figures may not add up to total due to rounding.

Table K Deposits from Customers

(HK\$ bn)	All Authorized Institutions				Retail Banks			
	Demand	Savings	Time	Total	Demand	Savings	Time	Total
Hong Kong Dollar ^(a)								
2004	272	1,033	713	2,018	250	1,023	601	1,874
2005	206	742	1,183	2,132	190	734	992	1,916
2006	238	933	1,397	2,568	219	924	1,140	2,283
2007	296	1,110	1,669	3,075	273	1,096	1,305	2,674
2008	321	1,254	1,459	3,034	295	1,239	1,161	2,695
Foreign Currency								
2004	72	399	1,378	1,848	47	357	866	1,270
2005	86	402	1,448	1,936	56	353	917	1,326
2006	104	426	1,659	2,189	70	373	1,024	1,466
2007	162	520	2,112	2,794	112	451	1,200	1,763
2008	155	691	2,180	3,026	102	610	1,324	2,036
Total								
2004	344	1,432	2,090	3,866	297	1,379	1,468	3,144
2005	292	1,144	2,631	4,068	246	1,087	1,909	3,242
2006	341	1,359	3,057	4,757	289	1,297	2,163	3,749
2007	459	1,629	3,781	5,869	385	1,547	2,506	4,437
2008	475	1,945	3,639	6,060	397	1,849	2,486	4,731

(a) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total due to rounding.

Table L Geographical Breakdown of Net External Claims/ (Liabilities) of All Authorized Institutions

(HK\$ bn) Region/Economy	2007			2008		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Asia and Pacific	644	(301)	343	702	(169)	532
Australia	301	40	341	286	19	305
South Korea	316	32	348	248	41	289
Singapore	392	(100)	292	316	(92)	224
Japan	(109)	62	(46)	(77)	177	99
India	21	28	50	21	36	57
Malaysia	(7)	6	(1)	16	2	18
New Zealand	4	0	4	4	0	4
Sri Lanka	0	0	0	2	1	3
Maldives	2	0	2	2	0	2
Bangladesh	1	0	1	2	0	2
Republic of Kazakhstan	1	0	1	1	0	1
Vietnam	(1)	2	1	1	0	1
Laos	0	0	0	0	1	1
Vanuatu	0	(2)	(2)	0	0	0
Cambodia	0	0	(1)	0	0	0
Myanmar	0	0	0	(1)	0	(1)
Nepal	0	0	0	(1)	0	(1)
Indonesia	(2)	(4)	(6)	(1)	(4)	(5)
Western Samoa	0	(8)	(8)	0	(8)	(8)
Brunei	(6)	(2)	(8)	(9)	(2)	(11)
Philippines	(26)	(16)	(41)	(5)	(11)	(16)
Thailand	(35)	(7)	(43)	(15)	(7)	(22)
Macau SAR	(69)	(10)	(79)	(78)	0	(77)
Taiwan	65	(133)	(68)	48	(148)	(100)
Mainland China	(203)	(186)	(389)	(57)	(168)	(226)
Others	0	(5)	(5)	(1)	(6)	(7)
North America	139	184	324	168	176	345
United States	109	191	300	138	186	324
Canada	31	(7)	24	30	(9)	21
Caribbean	6	(22)	(16)	22	(41)	(19)
Cayman Islands	41	(8)	33	35	15	50
Bermuda	0	4	4	0	6	6
Netherlands Antilles	0	4	4	0	2	2
Panama	0	(1)	(1)	0	1	1
Bahamas	(35)	(9)	(44)	(13)	(9)	(22)
Others	0	(12)	(12)	0	(56)	(56)
Africa	(12)	(4)	(15)	3	(5)	(2)
South Africa	(3)	0	(3)	4	0	4
Mauritius	(9)	2	(7)	(1)	2	1
Nigeria	0	0	0	0	0	1
Liberia	0	(1)	(1)	0	(1)	(1)
Others	0	(5)	(5)	0	(6)	(6)

Table L Geographical Breakdown of Net External Claims/ (Liabilities) of All Authorized Institutions (cont.)

(HK\$ bn) Region/Economy	2007			2008		
	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)	Net Claims on/ (Liabilities to) Banks Outside Hong Kong	Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	Total Net Claims/ (Liabilities)
Latin America	4	(2)	1	5	(3)	2
Brazil	3	0	3	3	(1)	2
Chile	0	0	0	2	0	2
Mexico	0	0	0	0	0	1
Venezuela	0	(1)	(1)	0	(1)	(1)
Others	0	(2)	(1)	0	(2)	(1)
Eastern Europe	4	1	5	10	1	10
Western Europe	1,794	40	1,834	1,236	40	1,276
United Kingdom	974	(34)	940	793	(25)	769
France	296	(11)	285	201	10	212
Switzerland	137	(3)	134	92	(2)	90
Netherlands	97	21	118	87	(2)	85
Jersey	5	28	33	4	31	35
Luxembourg	8	2	10	24	4	28
Sweden	37	2	39	20	2	21
Republic of Ireland	31	22	53	17	2	19
Denmark	30	0	30	10	8	18
Norway	19	0	19	14	3	17
Austria	14	0	14	5	0	5
Malta	0	1	1	0	4	4
Finland	7	0	7	2	1	3
Turkey	2	0	2	1	1	2
Cyprus	0	0	0	0	2	2
Iceland	4	0	5	1	0	1
Portugal	1	0	1	1	0	1
Greece	0	1	1	0	1	1
Guernsey	(2)	2	(1)	0	0	0
Germany	65	3	68	(5)	0	(5)
Belgium	52	1	53	(8)	0	(8)
Italy	20	4	24	(12)	3	(9)
Spain	(4)	0	(4)	(13)	(1)	(15)
Others	0	0	1	1	(1)	0
Middle East	11	18	29	18	29	48
United Arab Emirates	17	15	31	15	24	39
Saudi Arabia	2	1	3	3	1	4
Qatar	1	2	3	1	2	3
Kuwait	0	1	2	1	1	1
Bahrain	(7)	0	(8)	0	0	0
Egypt	(1)	0	0	0	1	0
Others	(1)	0	(1)	(1)	0	(1)
Others ^(a)	7	0	6	20	1	21
Overall Total	2,598	(87)	2,510	2,185	29	2,213

(a) "Others" include economies not listed above and positions in relation to international organisations.

Figures may not add up to total due to rounding.

Abbreviations used in this Report

AI	– Authorized institution	HKD	– Hong Kong dollar
AML	– Anti-money-laundering	HKDPB	– Hong Kong Deposit Protection Board
APEC	– Asia-Pacific Economic Co-operation	HKFRSs	– Hong Kong Financial Reporting Standards
APG	– Asia/Pacific Group on Money Laundering	HKICL	– Hong Kong Interbank Clearing Limited
ASEAN	– Association of Southeast Asian Nations	HKICPA	– Hong Kong Institute of Certified Public Accountants
BIS	– Bank for International Settlements	HKMA	– Hong Kong Monetary Authority
BLR	– Best lending rate	HKMC	– Hong Kong Mortgage Corporation Limited
CAAP	– Capital adequacy assessment process	HKSAR	– Hong Kong Special Administrative Region
CAMEL	– Capital adequacy, Asset quality, Management, Earnings and Liquidity of banks	HSI	– Hang Seng Index
CAR	– Capital adequacy ratio	IA	– Insurance Authority
CBRC	– China Banking Regulatory Commission	IASB	– International Accounting Standards Board
CCASS	– Central Clearing and Settlement System	IMF	– International Monetary Fund
CCPI	– Composite Consumer Price Index	IPO	– Initial Public Offering
CCR	– Counterparty credit risk	IRB	– Internal ratings-based approach approach
CCRA	– Commercial Credit Reference Agency	ISC	– Investment Sub-Committee
CDOs	– Collateralised debt obligations	JETCO	– Joint Electronic Teller Services Limited
CDSs	– Credit default swaps	LEERS	– Linked Exchange Rate system
CEO	– Chief Executive Officer	LIBOR	– London Interbank Offered Rate
CEPA	– Closer Economic Partnership Arrangement	MFSC	– Monetary and Financial Stability Committee
CFT	– Counter-terrorist-financing	NAB	– New Arrangements to Borrow
CHATS	– Clearing House Automated Transfer System	NDIs	– Negotiable debt instruments
CLS	– Continuous Linked Settlement	OCL	– Octopus Cards Limited
CMU	– Central Moneymarkets Unit	OECD	– Organisation for Economic Co-operation and Development
CRA	– Credit rating agencies	OGC	– Office of the General Counsel
CRCC	– Credit Review and Compliance Committee	PBoC	– People's Bank of China
CSSO	– Clearing and Settlement Systems Ordinance	PvP	– Payment-versus-Payment
CU	– Convertibility Undertaking	QDII	– Qualified Domestic Institutional Investors
DCA	– Debt collection agency	RIs	– Registered Institutions
DTC	– Deposit-taking company	RM	– Ringgit Malaysia
DvP	– Delivery-versus-Payment	RMB	– Renminbi
ECAls	– External credit assessment institutions	RMC	– Risk Management and Compliance Division
EFAC	– Exchange Fund Advisory Committee	RMLs	– Residential mortgage loans
EFBN	– Exchange Fund Bills and Notes	RTGS	– Real Time Gross Settlement
EMEAP	– Executives' Meeting of East Asia-Pacific Central Banks	SFC	– Securities and Futures Commission
EPS	– Easy Pay System	SMEs	– Small and medium-sized enterprises
FATF	– Financial Action Task Force on Money Laundering	SPM	– Supervisory Policy Manual
F/CY	– Foreign currency	SRP	– Supervisory review process
FSF	– Financial Stability Forum	SSG	– Senior Supervisors Group
GAAP	– Generally Accepted Accounting Principles	SWIFT	– Society for Worldwide Interbank Financial Telecommunication
GDP	– Gross Domestic Product (in real terms unless otherwise stated)	TMA	– Treasury Markets Association
GSC	– Governance Sub-Committee	USD	– US dollar
HIBOR	– Hong Kong Interbank Offered Rate	VaR	– Value-at-Risk
HKASs	– Hong Kong Accounting Standards	yoy	– Year-on-year

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HONG KONG MONETARY AUTHORITY

55/F, Two International Finance Centre,
8 Finance Street, Central, Hong Kong
Telephone : (852) 2878 8196
Facsimile : (852) 2878 8197
E-mail : hkma@hkma.gov.hk

www.hkma.gov.hk