

The Exchange Fund

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Report of the Director of Audit to the Financial Secretary

I have audited the statement of the accounts on pages 74 to 97 which has been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of the Monetary Authority and the Director of Audit

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

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

Basis of opinion

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

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

Opinion

In my opinion the statement of the accounts gives a true and fair view of the state of affairs of the Exchange Fund as at 31 December 2001 and of its deficit and cash flows for the year then ended and has been properly prepared in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance.

Audit Commission
Hong Kong
28 March 2002

Dominic Y T Chan
Director of Audit

Exchange Fund – Income and Expenditure Account			
for the year ended 31 December 2001			
(Expressed in millions of Hong Kong dollars)	Notes	2001	2000
INCOME			
Interest income			
Interest income on debt securities		34,091	29,710
Other interest income		5,818	6,643
Total interest income		39,909	36,353
Dividend income from listed equity securities		3,668	4,871
Net realised and revaluation gains/(losses) on other investments in securities		(24,956)	10,695
Other net realised and revaluation gains/(losses)		1,801	4,370
Net exchange losses		(13,059)	(11,189)
Bank licence fees		154	151
Others		26	22
TOTAL INCOME		7,543	45,273
EXPENDITURE			
Note and coin expenses	3(a)	144	172
Operating expenses	3(b)	1,070	983
Interest expenses	3(c)	10,839	27,877
TOTAL EXPENDITURE		12,053	29,032
SURPLUS/(DEFICIT) FOR THE YEAR	21	(4,510)	16,241

No separate statement of recognised gains and losses has been prepared as the surplus/(deficit) for the year would be the only component of this statement.

The notes on pages 77 to 97 form part of these accounts.

Exchange Fund – Balance Sheet

as at 31 December 2001

(Expressed in millions of Hong Kong dollars)	Notes	2001	2000
ASSETS			
Cash and money at call		13,848	16,953
Placements with banks and other financial institutions	4	85,403	56,093
Investment securities	5	300	300
Other investments in securities	6	853,898	923,360
Gold	7	145	142
Thailand financing package	8	4,149	6,724
Other assets	9	18,534	17,448
Investments in subsidiaries	10	2,145	2,145
Investment in associate	11	7	14
Fixed assets	12	717	184
TOTAL ASSETS	13	979,146	1,023,363
LIABILITIES AND FUND RESOURCES			
Certificates of Indebtedness	14	107,545	99,265
Coins in circulation	14	5,691	5,918
Balance of the banking system	15	671	669
Exchange Fund Bills and Notes	16	118,157	109,288
Placements by banks and other financial institutions	17	47,122	35,389
Placements by other Hong Kong Special Administrative Region government funds	18	380,602	417,162
Placements by Hong Kong statutory bodies		5,124	9,660
Other liabilities	19	11,645	38,913
Total liabilities		676,557	716,264
Accumulated surplus	21	302,589	307,099
TOTAL LIABILITIES AND FUND RESOURCES		979,146	1,023,363

Joseph Yam

Monetary Authority
28 March 2002

The notes on pages 77 to 97 form part of these accounts.

Exchange Fund – Cash Flow Statement

for the year ended 31 December 2001

(Expressed in millions of Hong Kong dollars)	Notes	2001	2000
Net cash inflow/(outflow) from operating activities	22(a)	28,331	(58,738)
Returns on investments and servicing of finance			
Interest received on loan to associate		1	1
Dividend received from subsidiaries		–	27
Net cash inflow from returns on investments and servicing of finance		1	28
Investing activities			
Purchase of fixed assets		(597)	(39)
Repayment of loan by associate		7	8
Net cash outflow from investing activities		(590)	(31)
Net increase/(decrease) in cash and cash equivalents		27,742	(58,741)
Cash and cash equivalents at 1 January		85,609	144,082
Effect of foreign exchange movements		(298)	268
Cash and cash equivalents at 31 December	22(b)	113,053	85,609

The notes on pages 77 to 97 form part of these accounts.

Exchange Fund – Notes on the Accounts

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

1. Principal Activities

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund (“the Fund”), manages the Fund in accordance with the provisions of the Exchange Fund Ordinance. The principal activities of the Fund are the safeguarding of the exchange value of the currency of Hong Kong and the maintaining of the stability and integrity of Hong Kong’s monetary and financial systems.

The principal activities of the subsidiaries are shown in Note 10.

2. Principal Accounting Policies

(a) Basis of preparation

- (i) Group accounts are not prepared in view of the insignificant amounts involved in the subsidiaries and associate.
- (ii) These accounts have been prepared using the fair value measurement basis, as modified by the use of historical cost for investment securities, other assets, investments in subsidiaries and associate, fixed assets, placements by other Hong Kong Special Administrative Region (“HKSAR”) government funds for which interest is payable at rates determined by reference to the investment income of the Fund and other liabilities, and in accordance with accounting principles generally accepted in Hong Kong, and comply with all applicable Statements of Standard Accounting Practice and Interpretations issued by the Hong Kong Society of Accountants. Fair value represents the market price of a financial instrument for which there is a published price quotation in an active securities market. Where such a market price is not available, fair value represents the valuation of a financial instrument according to a price matrix of discounted cash flows using applicable interest rates for discounting.

(b) Investments

- (i) Investments in securities

Investments in debt and equity securities, except those held as investments in subsidiaries and associate, are accounted for as follows.

Investments in securities are recognised as assets from the date on which the Fund is bound by the contract which gives rise to them. They are classified as investment securities and other investments in securities.

Investment securities

Investment securities are securities which are intended to be held on a continuing basis, and which are held for an identified long term purpose documented at the time of acquisition or change of purpose and are clearly identifiable for the documented purpose.

Investment securities are included in the balance sheet at cost less provision for any diminution in value which is other than temporary.

Exchange Fund – Notes on the Accounts (cont.)

Other investments in securities

Other investments in securities are those which are not classified as investment securities and are stated at fair value at the balance sheet date.

Changes in fair value of these investments are recognised in the income and expenditure account in "Net realised and revaluation gains/(losses) on other investments in securities" as they arise.

Gains and losses on sale of these investments are accounted for in the income and expenditure account in "Net realised and revaluation gains/(losses) on other investments in securities" in the period in which the disposal occurs as the difference between the net sales proceeds and the carrying amount of the securities.

(ii) Investments in subsidiaries and associate

Investments in subsidiaries and associate are stated at cost less provision for any diminution in value which is other than temporary as determined by management.

The results of subsidiaries and associate are accounted for by the Fund on the basis of dividends when they are declared.

(c) Placements with banks and other financial institutions

Placements with banks and other financial institutions are valued in the balance sheet according to a price matrix of discounted cash flows using applicable interest rates for discounting. Changes in value of these placements are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(d) Exchange Fund Bills and Notes

Where Exchange Fund Bills and Notes have been issued at a premium or discount, those premiums and discounts are amortised over the period from the date of issue to the date of redemption and are included in the income and expenditure account in "Interest expense". Exchange Fund Bills and Notes are stated in the balance sheet at market value. Changes in market value of Exchange Fund Bills and Notes are recognised in the income and expenditure account in "Other net realised and revaluation gains/(losses)" as they arise.

On redemption of the Exchange Fund Bills and Notes, the resulting gains and losses, being the difference between the redemption amount and the carrying amount, are recognised in the income and expenditure account in "Other net realised and revaluation gains/(losses)" in the period in which the redemption takes place.

(e) Placements by other HKSAR government funds and other placements

Placements by other HKSAR government funds for which interest is payable at market-based rates are valued according to a price matrix of discounted cash flows using applicable interest rates for discounting. Changes in value of these placements are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)". In the balance sheet, these placements are stated at the principal amounts payable at the balance sheet date with the revaluation differences included in "Other liabilities".

Exchange Fund – Notes on the Accounts (cont.)

Placements by other HKSAR government funds for which interest is payable at rates determined by reference to the investment income of the Fund are stated at the principal amounts payable at the balance sheet date.

Placements by banks, other financial institutions and Hong Kong statutory bodies are valued in the balance sheet according to a price matrix of discounted cash flows using applicable interest rates for discounting. Changes in value of these placements are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(f) Repurchase and resale agreements

Where securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in respect of the consideration received in "Placements by banks and other financial institutions". Conversely, securities purchased under analogous commitments to resell are not recognised on the balance sheet and the consideration paid is recorded in "Placements with banks and other financial institutions". At the balance sheet date consideration received or paid under repurchase and resale agreements is valued according to a price matrix of discounted cash flows using applicable interest rates for discounting. Gains or losses arising from revaluation are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(g) Securities lending agreements

Where securities are loaned with the receipt of cash or securities collateral, they remain on the balance sheet. Where cash collateral is received, a liability is recorded in respect of the cash received in "Placements by banks and other financial institutions". At the balance sheet date, this liability is valued according to a price matrix of discounted cash flows using applicable interest rates for discounting. Gains or losses arising from revaluation are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(h) Foreign currency translation

Assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the rates of exchange ruling at the balance sheet date. Exchange gains and losses on foreign currency translation are included in the income and expenditure account in "Net exchange losses".

Certificates of Indebtedness and coins in circulation, both of which are denominated in Hong Kong dollars but are issued and redeemed in US dollars at the linked exchange rate of US\$1=HK\$7.80, are stated in the accounts at their Hong Kong dollar face value. At the balance sheet date the difference between their Hong Kong dollar face value and the market value of the US dollars required for their redemption is included in "Other assets".

Foreign currency income and expenditure are translated into Hong Kong dollars at the exchange rates prevailing at the transaction dates.

(i) Off-balance sheet financial instruments

Forward foreign exchange contracts are marked to market at the balance sheet date with the resultant revaluation gains and losses being included in the income and expenditure account in "Net exchange losses".

Exchange Fund – Notes on the Accounts (cont.)

Interest rate swap contracts are marked to market at the balance sheet date with the resultant revaluation gains and losses being included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

Revaluation gains or losses on forward foreign exchange contracts and interest rate swap contracts are included in the balance sheet as "Other assets" or "Other liabilities" as appropriate.

Stock index futures contracts and bond futures contracts are marked to market at the balance sheet date with their marked to market value being included in the balance sheet as "Other assets" or "Other liabilities" as appropriate. The resultant revaluation gains and losses are included in the income and expenditure account in "Other net realised and revaluation gains/(losses)".

(j) Fixed assets

Fixed assets, including premises, furniture, fixtures and equipment, motor vehicles, personal computers and capitalised systems development costs, are stated at cost less accumulated depreciation. Freehold land is not depreciated. All other fixed assets are depreciated on a straight-line basis over their respective estimated useful lives of between 3 and 39 years.

On disposal of fixed assets, the profit or loss is calculated as the difference between the net sales proceeds and the net carrying amount.

No periodic revaluation of premises and equipment has been carried out.

(k) Revenue recognition

Interest income is recognised on an accrual basis and dividend income is recognised when the share price goes ex-dividend.

Premiums and discounts on acquisition of debt securities are dealt with in the income and expenditure account in "Net realised and revaluation gains/(losses) on other investments in securities" in the process of marking to market of such securities at the balance sheet date.

Bank licence fees are fees receivable from Authorised Institutions under the Banking Ordinance and are accounted for in the period when receivable.

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

(l) Interest expense

Interest expense is recognised on an accrual basis. Discounts and premiums relating to borrowings are amortised on a straight-line basis over the respective remaining lives of the instruments. For a majority portion of the placements by other HKSAR government funds, interest is payable at rates determined by reference to the investment income of the Fund. For the rest of such placements, interest is payable at market-based rates.

(m) Related parties

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

Exchange Fund – Notes on the Accounts (cont.)

(n) Cash and cash equivalents

Cash and cash equivalents are cash, placements with banks and other financial institutions and short-term highly liquid investments which were within three months of maturity when placed or acquired, less placements by banks and other financial institutions repayable within three months from the date of the placement.

(o) Staff retirement schemes

The Hong Kong Monetary Authority (“HKMA”) operates two defined contribution schemes, the Provident Fund Scheme and the Mandatory Provident Fund Scheme. Under the schemes, contributions applicable each year are charged to the income and expenditure account. The assets of the staff retirement schemes are held separate from the Fund.

(p) Operating leases

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

(q) Segment reporting

The activities of the Fund managed by the HKMA comprise four business segments. These are management of funds under the Currency Board Account, management of funds representing the general reserve assets of the Fund, banking supervision and monetary management. As the assets, revenue and overall results of banking supervision and monetary management are not significant, these two segments are combined with the segment for management of funds representing the general reserve assets of the Fund. Details on this combined segment are disclosed in Note 23 together with the Currency Board Account segment. There is no disclosure of geographic segments as the HKMA operates predominantly in one location. In line with the normal practice of central banking institutions, further breakdown of the investments by currencies or geographic markets is not disclosed.

3. Expenditure

(a) **Note and coin expenses** represent reimbursements to the note-issuing banks in respect of note-issuing expenses, and expenses incurred directly by the Fund in issuing coins.

(b) Operating expenses

	2001	2000
Staff costs		
Salaries and other staff costs	457	414
Retirement benefit costs	23	22
Premises and equipment expenses		
Depreciation charges	64	68
Operating lease charges	81	78
Other premises and equipment expenses	47	41
Other operating expenses	398	360
TOTAL	1,070	983

Exchange Fund – Notes on the Accounts (cont.)

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

HKS	2001	2000
1,000,000 or below	1	2
1,000,001 to 1,500,000	1	–
1,500,001 to 2,000,000	1	–
2,000,001 to 2,500,000	–	1
3,000,001 to 3,500,000	2	1
3,500,001 to 4,000,000	3	3
4,000,001 to 4,500,000	1	–
4,500,001 to 5,000,000	1	2
5,000,001 to 5,500,000	–	1
5,500,001 to 6,000,000	1	1
6,000,001 to 6,500,000	1	1
6,500,001 to 7,000,000	1	–
9,000,001 to 9,500,000	1	1
	14	13

(c) Interest expense

	2001	2000
Interest on placements by other HKSAR government funds:		
With interest at market-based rates	588	880
With interest at rates determined by reference to the investment income of the Fund	1,572	18,052
Other interest expense	8,679	8,945
TOTAL	10,839	27,877

4. Placements with Banks and other Financial Institutions

	2001	2000
Placements with banks and other financial institutions in respect of resale agreements	42,844	21,379
Other placements with banks and other financial institutions	42,559	34,714
TOTAL	85,403	56,093

5. Investment Securities

Investment securities comprise 3,000 unlisted shares of the Bank for International Settlements with a nominal value of 2,500 Swiss gold francs each (25% paid).

Exchange Fund – Notes on the Accounts (cont.)

6. Other Investments in Securities

Other investments in securities comprise debt securities and equity securities:

At fair value	2001	2000
Debt securities		
Treasury bills and commercial papers		
Listed outside Hong Kong	254	1,505
Unlisted	84,354	138,672
Certificates of deposit		
Unlisted	25,182	53,898
Other debt securities		
Listed		
In Hong Kong	6,291	7,739
Outside Hong Kong	496,417	442,265
Unlisted	120,214	85,755
Total debt securities	732,712	729,834
Equity securities		
Listed		
In Hong Kong (a)	85,864	152,942
Outside Hong Kong	35,322	40,584
Total equity securities	121,186	193,526
TOTAL	853,898	923,360

(a) Equity securities listed in Hong Kong

The investment benchmark of the Fund allocates 5% of its assets to the Hong Kong equity market as a long-term investment. The disposal of the Hong Kong equity portfolio, other than the long-term investment portfolio, is conducted in an orderly manner with minimum disruption to the market. In November 1999, a disposal program was implemented through the launching of The Tracker Fund of Hong Kong ("TraHK"), a collective investment fund designed to provide investment results that closely correspond to the performance of the Hang Seng Index. Proceeds from TraHK's initial offer were used to buy shares from the Fund. Further disposals were made through the Tap Facility which is a means for the Fund to continue passively selling more shares into TraHK in response to investor demand. Under the Tap Facility, TraHK units can be created for cash which is used to purchase Hong Kong equity shares from the Fund. In 2001, disposal of Hong Kong equity portfolio through the Tap Facility amounted to HK\$35.2 billion (2000 – HK\$46.6 billion).

Exchange Fund – Notes on the Accounts (cont.)

7. Gold

	2001	2000
Gold, at market value		
66,916 ounces (2000 – 66,916 ounces)	145	142

8. Thailand Financing Package

On 21 September 1997, the HKMA participated in a financing package organised for Thailand by the International Monetary Fund ("IMF"). The financing package is in the form of a Currency Swap Agreement ("the Agreement") between the Bank of Thailand ("BOT") and a number of Asian central banks and multinational institutions, including the HKMA and the IMF. Under the Agreement, the HKMA entered into swap transactions to exchange US dollars for Thai Baht up to a maximum of US\$1 billion for a maximum period of five years. At the end of the agreed period for each swap transaction, the exchange of currencies will be reversed and the US dollars to be received by the HKMA will be equivalent to the original principal swapped plus interest at market rate. The transaction is accounted for as a US dollar loan to reflect its economic substance. Since the first drawdown made in October 1997, the HKMA has released a total of US\$862 million under the Agreement. In October 1999, the BOT gave notice that it would not draw down on the remaining US\$138 million. In April 2001, the BOT started to repay the principal of the loan in instalments in accordance with the terms and conditions of the Agreement. Up to 31 December 2001, the BOT had made repayments totalling US\$330 million. As at 31 December 2001, the total outstanding principal and accrued interest due from the BOT amounted to US\$532 million (2000 – US\$862 million) and US\$4 million (2000 – US\$12 million) respectively.

9. Other Assets

	2001	2000
Staff housing loans	334	296
Revaluation gains on off-balance sheet items which are marked to market	3,347	3,768
Revaluation difference on Certificates of Indebtedness and coins in circulation	30	1
Prepayments and receivables	14,823	13,383
TOTAL	18,534	17,448

Exchange Fund – Notes on the Accounts (cont.)

10. Investments in Subsidiaries

	2001	2000
Unlisted shares, at cost	2,145	2,145

The following is a list of the subsidiaries as at 31 December 2001 and 2000:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Exchange Fund's interest in equity capital
Hong Kong Note Printing Limited	Hong Kong	Banknotes printing	HK\$255,000,000	55%
The Hong Kong Mortgage Corporation Limited	Hong Kong	Investment in mortgages, mortgage securitisation and guarantee	HK\$2,000,000,000	100%
Exchange Fund Investment Limited	Hong Kong	Investment management	HK\$5,000,000	100%
Hong Kong Institute for Monetary Research	Hong Kong	Research	HK\$2	100%

Net aggregate amounts attributable to the Fund of profits less losses of the subsidiaries that are not dealt with in these accounts are as follows:

	2001	2000
For the current financial year:		
Hong Kong Note Printing Limited	25.1	10.4
The Hong Kong Mortgage Corporation Limited	255.5	233.1
Exchange Fund Investment Limited	–	–
Hong Kong Institute for Monetary Research	(0.5)	0.9
	280.1	244.4
For the previous financial years since acquisition:		
Hong Kong Note Printing Limited	177.4	167.0
The Hong Kong Mortgage Corporation Limited	590.5	357.4
Exchange Fund Investment Limited	–	–
Hong Kong Institute for Monetary Research	(1.0)	(1.9)
	766.9	522.5

Exchange Fund – Notes on the Accounts (cont.)

Net aggregate amounts due from/(to) the subsidiaries are as follows:

	2001	2000
Hong Kong Note Printing Limited	0.7	0.4
The Hong Kong Mortgage Corporation Limited	0.3	388.3
Exchange Fund Investment Limited	(13.0)	(11.7)
Hong Kong Institute for Monetary Research	1.8	1.0
	(10.2)	378.0

As at 31 December 2001, none (2000 – HK\$388 million) of the total of HK\$10,500 million (2000 – HK\$9,000 million) fixed rate notes issued by The Hong Kong Mortgage Corporation Limited was held by the Fund.

The Hong Kong Mortgage Corporation Limited has unissued authorised share capital of HK\$1 billion (2000 – HK\$1 billion) which is callable from the Fund.

11. Investment in Associate

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

The breakdown of the investment in associate is:

	2001	2000
Unlisted shares, at cost (HK\$5,000)	–	–
Loans to associate	7	14
TOTAL	7	14

The loans to Hong Kong Interbank Clearing Limited are unsecured and bear a fixed rate of interest at 1% over 3-month HIBOR per annum, repayable by 16 quarterly instalments starting from January 1999.

Exchange Fund – Notes on the Accounts (cont.)

12. Fixed Assets

	Premises	Other Fixed Assets	Total
Cost			
At 1 January 2001	7	398	405
Additions	558	39	597
Disposals	–	(14)	(14)
At 31 December 2001	565	423	988
Accumulated depreciation			
At 1 January 2001	1	220	221
Charge for the year	–	64	64
Written back on disposal	–	(14)	(14)
At 31 December 2001	1	270	271
Net book value at 31 December 2001	564	153	717
Net book value at 31 December 2000	6	178	184

Additions include the deposit and partial payment for the purchase of new office premises in Hong Kong amounting to HK\$558 million. No depreciation of this amount was made in 2001.

13. Total Assets

	2001	2000
Foreign currency assets	877,427	856,680
Hong Kong dollar assets	101,719	166,683
TOTAL	979,146	1,023,363

The Fund holds Hong Kong dollar and foreign currency assets. A large proportion of the Fund's foreign currency assets is held in US dollars. Apart from the US dollar assets, the Fund also holds assets denominated in fully convertible foreign currencies.

Total foreign currency assets and unsettled spot and forward foreign exchange transactions are as follows:

	2001	2000
Foreign currency assets excluding unsettled spot and forward transactions	877,427	856,680
Net unsettled spot and forward transactions	–	–
TOTAL	877,427	856,680
US\$ million equivalent	112,521	109,832

The Fund's assets are held in deposit, trustee and safe-keeping accounts with banks, central banks and custodial organisations situated in Hong Kong and other major financial centres.

Exchange Fund – Notes on the Accounts (cont.)

14. Certificates of Indebtedness 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. Payments for the issuance and redemption of notes against these Certificates are made in US dollars at a fixed rate of US\$1=HK\$7.80. Consistent with the requirement for backing banknote issuance with US dollars, the issue and withdrawal of coins are conducted against US dollars at a fixed rate of US\$1=HK\$7.80.

15. Balance of the Banking System

Under the interbank payment system based on Real Time Gross Settlement principles, all licensed banks maintain a Hong Kong dollar clearing account with the HKMA for the account of the Fund. The aggregate balance in these accounts represents the total level of liquidity in the interbank market. Under the Convertibility Undertaking which came into effect from 7 September 1998, the HKMA undertook to convert Hong Kong dollars in the clearing accounts maintained by licensed banks with the HKMA into US dollars at the fixed exchange rate of HK\$7.75 to US\$1. In accordance with a scheme announced by the HKMA on 26 November 1998, starting from 1 April 1999 the exchange rate under the Convertibility Undertaking moved from HK\$7.75 by 1 pip a day over a 500-day period and reached HK\$7.8 on 12 August 2000. Since then, the exchange rate under the Convertibility Undertaking has remained at HK\$7.8 to US\$1.

16. Exchange Fund Bills and Notes

	2001	2000
Exchange Fund Bills	74,608	72,147
Exchange Fund Notes	43,549	37,141
TOTAL	118,157	109,288

Exchange Fund Bills are issued by the Fund for maturities not exceeding one year. Exchange Fund Notes are issued by the Fund with 2-year, 3-year, 5-year, 7-year and 10-year maturities.

17. Placements by Banks and other Financial Institutions

	2001	2000
Placements by banks and other financial institutions in respect of repurchase agreements	42,022	19,880
Other placements by banks and other financial institutions	5,100	15,509
TOTAL	47,122	35,389

Exchange Fund – Notes on the Accounts (cont.)

18. Placements by other HKSAR Government Funds

The breakdown of placements by other HKSAR government funds is:

	2001	2000
Placements with interest payable at market-based rates		
General Revenue Account	750	1,194
Capital Investment Fund	3,753	4,597
Loan Fund	8,419	7,650
Capital Works Reserve Fund	546	778
Innovation and Technology Fund	148	129
	13,616	14,348
Placements with interest payable at rates determined by reference to the investment income of the Fund		
General Revenue Account	85,666	113,144
Land Fund	247,227	234,546
Capital Works Reserve Fund	17,675	39,308
Civil Service Pension Reserve Fund	11,741	11,139
Disaster Relief Fund	31	21
Innovation and Technology Fund	4,646	4,656
	366,986	402,814
TOTAL	380,602	417,162

Placements by other HKSAR government funds are not permanently appropriated for the use of the Fund, but are repayable on demand when they are required to meet the obligations of the fiscal reserves.

19. Other Liabilities

	2001	2000
Interest payable on placements by other HKSAR government funds at rates determined by reference to the investment income of the Fund	1,572	22,366
Revaluation losses on off-balance sheet items which are marked to market	1,873	3,190
Provision for Tracker Fund Loyalty Bonus (a)	–	1,228
Accrued interest and other liabilities	8,200	12,129
TOTAL	11,645	38,913

(a) Tracker Fund Loyalty Bonus Scheme

Under the terms of the issue of the Tracker Fund of Hong Kong (see Note 6(a)), qualified Tracker Fund Unitholders received the second tranche of loyalty bonus on 12 November 2001, in the form of Tracker Fund Units ("Units"), based on a predetermined formula, the cost of which was borne by the Fund. Under the Scheme, the second tranche was the last and no provision was required as at 31 December 2001. The provision for loyalty bonus as at 31 December 2000 was HK\$1,228 million, which represented the market value of the Units required to satisfy entitlements to loyalty bonus Units.

Exchange Fund – Notes on the Accounts (cont.)

20. Maturity Profile

	2001						Total
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	After 5 years	Undated	
Assets							
Cash and money at call	13,848	-	-	-	-	-	13,848
Placements with banks and other financial institutions	-	85,403	-	-	-	-	85,403
Investment securities	-	-	-	-	-	300	300
Other investments in securities	-	117,321	94,577	292,756	228,058	121,186	853,898
Gold	-	-	-	-	-	145	145
Thailand financing package	-	230	2,860	1,059	-	-	4,149
	13,848	202,954	97,437	293,815	228,058	121,631	957,743
Liabilities							
Certificates of Indebtedness	107,545	-	-	-	-	-	107,545
Coins in circulation	5,691	-	-	-	-	-	5,691
Balance of the banking system	671	-	-	-	-	-	671
Exchange Fund Bills and Notes	-	51,955	30,647	27,644	7,911	-	118,157
Placements by banks and other financial institutions	-	47,122	-	-	-	-	47,122
Placements by other HKSAR government funds	368,784	4,869	6,949	-	-	-	380,602
Placements by Hong Kong statutory bodies	82	2,152	2,890	-	-	-	5,124
	482,773	106,098	40,486	27,644	7,911	-	664,912

Exchange Fund – Notes on the Accounts (cont.)

	2000						Total
	Repayable on demand	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	After 5 years	Undated	
Assets							
Cash and money at call	16,953	–	–	–	–	–	16,953
Placements with banks and other financial institutions	–	56,093	–	–	–	–	56,093
Investment securities	–	–	–	–	–	300	300
Other investments in securities	–	140,199	180,009	150,464	259,162	193,526	923,360
Gold	–	–	–	–	–	142	142
Thailand financing package	–	–	2,574	4,150	–	–	6,724
	16,953	196,292	182,583	154,614	259,162	193,968	1,003,572
Liabilities							
Certificates of Indebtedness	99,265	–	–	–	–	–	99,265
Coins in circulation	5,918	–	–	–	–	–	5,918
Balance of the banking system	669	–	–	–	–	–	669
Exchange Fund Bills and Notes	–	57,508	21,895	22,455	7,430	–	109,288
Placements by banks and other financial institutions	–	30,381	5,008	–	–	–	35,389
Placements by other HKSAR government funds	405,276	7,922	3,964	–	–	–	417,162
Placements by Hong Kong statutory bodies	93	6,824	2,743	–	–	–	9,660
	511,221	102,635	33,610	22,455	7,430	–	677,351

21. Accumulated Surplus

	2001	2000
Accumulated surplus at 1 January	307,099	290,858
Surplus/(Deficit) for the year	(4,510)	16,241
Accumulated surplus at 31 December	302,589	307,099

Exchange Fund – Notes on the Accounts (cont.)

22. Notes to the Cash Flow Statement

(a) Reconciliation of surplus/(deficit) for the year to net cash inflow/(outflow) from operating activities

	2001	2000
Surplus/(Deficit) for the year	(4,510)	16,241
Interest income on loan to associate	(1)	(1)
Dividend received from subsidiaries	–	(27)
Amortisation of premiums and discounts on Exchange Fund Bills and Notes	3,031	4,082
Depreciation	64	68
Change in placements with banks and other financial institutions	889	7,759
Change in other investments in securities	66,913	(77,705)
Change in gold	(3)	9
Change in Thailand financing package	2,575	(23)
Change in other assets	(1,086)	(7,108)
Change in Certificates of Indebtedness and coins in circulation	8,053	(18,789)
Change in balance of the banking system	2	(7,291)
Change in Exchange Fund Bills and Notes	5,838	3,378
Change in placements by banks and other financial institutions	14,632	14,227
Change in placements by other HKSAR government funds	(36,560)	24,956
Change in placements by Hong Kong statutory bodies	(4,536)	(326)
Change in other liabilities	(27,268)	(17,920)
Elimination of exchange differences	298	(268)
Net cash inflow/(outflow) from operating activities	28,331	(58,738)

(b) Analysis of the balances of cash and cash equivalents

	2001	2000
Cash and money at call	13,848	16,953
Treasury bills and commercial papers	18,512	20,671
Certificates of deposit	390	780
Placements with banks and other financial institutions	85,403	55,204
Placements by banks and other financial institutions	(5,100)	(7,999)
TOTAL	113,053	85,609

Exchange Fund – Notes on the Accounts (cont.)

23. Segment Reporting

The business activities of the Fund managed by the HKMA comprise:

- Management of funds under the Currency Board Account (a)
- Management of funds representing the general reserve assets of the Fund
- Banking supervision
- Monetary management

As the assets, revenue and overall results of the latter two activities are not significant, they are presented as part of the assets, revenue and results of management of funds representing the general reserve assets of the Fund.

	Currency Board Account		Reserve Management and Other Activities		Re-allocation (c)		Total of the Fund	
	2001	2000	2001	2000	2001	2000	2001	2000
Income	11,825	15,678	(4,282)	29,595	-	-	7,543	45,273
Expenditure								
Interest expense	5,631	6,621	5,208	21,256	-	-	10,839	27,877
Other expenses (b)	-	-	1,214	1,155	-	-	1,214	1,155
	5,631	6,621	6,422	22,411	-	-	12,053	29,032
Surplus/(Deficit) for the year	6,194	9,057	(10,704)	7,184	-	-	(4,510)	16,241

Exchange Fund – Notes on the Accounts (cont.)

	Currency Board Account		Reserve Management and Other Activities		Re-allocation (c)		Total of the Fund	
	2001	2000	2001	2000	2001	2000	2001	2000
Assets								
Backing Assets								
Investment in designed US dollar assets	254,200	240,056	-	-	-	-	254,200	240,056
Interest receivable on designated US dollar assets	2,370	1,593	-	-	-	-	2,370	1,593
Net accounts payable	-	(27) (c)(i)	-	-	-	828	-	801
Other investments	-	- (c)(ii)	701,171	758,603	375	348	701,546	758,951
Other assets	-	- (c)(iii)	18,445	21,962	2,585	-	21,030	21,962
TOTAL ASSETS	256,570	241,622 (A)	719,616	780,565	2,960	1,176	979,146	1,023,363
Liabilities								
Monetary Base								
Certificates of Indebtedness	107,545	99,265	-	-	-	-	107,545	99,265
Coins in circulation	5,691	5,918	-	-	-	-	5,691	5,918
Balance of the banking system	671	669	-	-	-	-	671	669
Exchange Fund Bills and Notes	118,157	109,288	-	-	-	-	118,157	109,288
Interest payable on Exchange Fund Notes	624	612	-	-	-	-	624	612
Net accounts receivable	(2,947)	(348) (c)(ii)(iii)	-	-	2,960	348	13	-
Placements by banks and other financial institutions	-	-	47,122	35,389	-	-	47,122	35,389
Placements by other HKSAR government funds	-	-	380,602	417,162	-	-	380,602	417,162
Placements by Hong Kong statutory bodies	-	-	5,124	9,660	-	-	5,124	9,660
Other liabilities	-	- (c)(i)	11,008	37,473	-	828	11,008	38,301
	229,741	215,404 (B)	443,856	499,684	2,960	1,176	676,557	716,264
Accumulated surplus								
Balance brought forward	26,218	22,601	280,881	268,257	-	-	307,099	290,858
Surplus/(Deficit) for the year	6,194	9,057	(10,704)	7,184	-	-	(4,510)	16,241
Transfer from Currency Board Account to general reserves (d)	(5,583)	(5,440)	5,583	5,440	-	-	-	-
	26,829	26,218	275,760	280,881	-	-	302,589	307,099
TOTAL LIABILITIES AND FUND RESOURCES	256,570	241,622	719,616	780,565	2,960	1,176	979,146	1,023,363
Backing Ratio [(A)/(B)] x 100%	111.68%	112.17%						

Exchange Fund – Notes on the Accounts (cont.)

- (a) 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, coins in circulation, the balance of the banking system and Exchange Fund Bills and Notes. While specific assets of the Fund have been earmarked for backing the monetary base, all the Fund assets have continued to be available for the purpose of supporting the Hong Kong dollar exchange rate under the Linked Exchange Rate system.
- (b) Other expenses have not been allocated to the Currency Board Account as the amounts involved are not material.
- (c) For the purposes of the Currency Board Account, certain assets and liabilities of the Fund's accounts need to be included in the Monetary Base and Backing Assets respectively but as negative amounts. Such presentation is necessary to allow proper computation of the backing ratio. As at 31 December 2001, these negative amounts comprised:
- (i) "Other liabilities", Nil (2000 – HK\$828 million) representing accounts payable included in the Backing Assets to offset the corresponding investments purchased but not yet settled;
 - (ii) "Other investments", HK\$375 million (2000 – HK\$348 million) representing advances to banks secured on Exchange Fund Bills and Notes included in the Monetary Base to offset the corresponding Exchange Fund Bills and Notes; and
 - (iii) "Other assets" of HK\$2,585 million (2000 – Nil) included in the Monetary Base, which consisted of three components:
 - HK\$2,580 million (2000 – Nil) representing accounts receivable to offset the corresponding Exchange Fund Bills and Notes issued on tender date but not yet settled;
 - HK\$1 million (2000 – Nil) representing interests receivable on Hong Kong dollar interest rate swaps used as a means to manage the cost of issuing Exchange Fund Notes; and
 - HK\$4 million (2000 – Nil) representing receivables pertaining to revaluation gains on Hong Kong dollar interest rate swaps used as a means to manage the cost of issuing Exchange Fund Notes.
- (d) In accordance with an arrangement approved by the Financial Secretary in January 2000, assets can be transferred between the backing and general reserve portfolios when the backing ratio reaches either the upper trigger point (112.5%) or the lower trigger point (105%). This arrangement allows transfer of excess assets out of the backing portfolio to maximise their earning potential while ensuring that there are sufficient liquid assets in the backing portfolio.

Exchange Fund – Notes on the Accounts (cont.)

24. Commitments

(a) Capital commitments

Capital expenditure authorised but not provided for in these accounts amounted to:

	2001	2000
Contracted	3,198	–
Not contracted	715	4,485
TOTAL	3,913	4,485

(b) Loan to the International Monetary Fund

On 27 January 1997, the HKMA participated in the New Arrangements to Borrow (“NAB”), a standby credit facility to the IMF for coping with instability in the international monetary system. In respect of this, the HKMA undertakes to lend foreign currencies to the IMF up to HK\$3,332 million equivalent as at 31 December 2001 (2000 – HK\$3,455 million equivalent), in the form of a term loan of five year maturity bearing prevailing market interest rates. As at 31 December 2001, there was no outstanding balance due from the IMF under the NAB (2000 – Nil).

(c) Lease commitments

Total future minimum lease payments under non-cancellable operating leases at the balance sheet date are analysed as follows:

	2001	2000
Premises		
Not later than one year	89	84
Later than one year and not later than five years	108	192
Later than five years	–	–
TOTAL	197	276

Exchange Fund – Notes on the Accounts (cont.)

25. Off-Balance Sheet Items

	2001	2000
Spot and forward foreign exchange contracts		
Outstanding contract amount	115,737	98,318
Gross replacement costs	874	1,820
Interest rate swap contracts		
Notional principal	29,496	31,900
Gross replacement costs	2,708	1,795
Stock index futures contracts		
Notional principal	28,666	21,059
Gross replacement costs	189	427
Bond futures contracts		
Notional principal	176	112
Gross replacement costs	–	1

26. Contingent Liabilities

The Fund has a contingent liability up to 5.6 million Swiss gold francs or HK\$113.2 million equivalent as at 31 December 2001 (2000 – 5.6 million Swiss gold francs or HK\$111.7 million equivalent), in respect of the uncalled portion of its 3,000 shares held in the Bank for International Settlements.

27. Material Related Party Transactions

The Fund takes placements from other HKSAR government funds and a number of Hong Kong statutory bodies, as shown on the balance sheet. During the year, interest expenses on placements from other HKSAR government funds and Hong Kong statutory bodies amounted to HK\$2,160 million (2000 – HK\$18,932 million) and HK\$271 million (2000 – HK\$593 million) respectively.

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.

28. Approval of Accounts

The accounts were approved by the Exchange Fund Advisory Committee on 28 March 2002.