

The Exchange Fund

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Report of the Director of Audit



Audit Commission
The Government of the Hong Kong Special Administrative Region

Independent Audit Report

To the Financial Secretary

I certify that I have audited the financial statements of the Exchange Fund set out on pages 112 to 193, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2009, and their income and expenditure accounts, statements of comprehensive income, statements of changes in equity and statements of cash flows 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 2009 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

1 April 2010

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

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2009	2008	2009	2008
INCOME					
Interest income		22,628	37,491	21,303	35,665
Dividend income		7,181	8,219	7,379	8,442
Net realised and revaluation gains/(losses)		72,810	(115,604)	72,777	(115,587)
Net exchange gains/(losses)		9,762	(12,484)	9,772	(12,440)
Investment income/(loss)	4(a)	112,381	(82,378)	111,231	(83,920)
Bank licence fees		134	141	134	141
Other income		388	329	127	106
TOTAL INCOME/(LOSS)		112,903	(81,908)	111,492	(83,673)
EXPENDITURE					
Interest expense	4(b)	(36,063)	(51,248)	(35,784)	(50,138)
Operating expenses	4(c)	(2,622)	(2,657)	(2,403)	(2,455)
Note and coin expenses	4(d)	(333)	(229)	(333)	(229)
Write back of impairment losses on loans/ (Impairment losses on loans)		37	(36)	-	-
TOTAL EXPENDITURE		(38,981)	(54,170)	(38,520)	(52,822)
SURPLUS/(DEFICIT) BEFORE SHARE OF PROFIT OF ASSOCIATE AND JOINT VENTURE					
		73,922	(136,078)	72,972	(136,495)
Share of profit of associate and joint venture, net of tax		2	2	-	-
SURPLUS/(DEFICIT) BEFORE TAXATION					
		73,924	(136,076)	72,972	(136,495)
Income tax		(150)	(35)	-	-
SURPLUS/(DEFICIT) FOR THE YEAR					
		73,774	(136,111)	72,972	(136,495)
ATTRIBUTABLE TO:					
Owner of the Fund		73,759	(136,131)	72,972	(136,495)
Minority interests		15	20	-	-
		73,774	(136,111)	72,972	(136,495)

The notes on pages 118 to 193 form part of these financial statements.

Exchange Fund – Statement of Comprehensive Income

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2009	2008	2009	2008
SURPLUS / (DEFICIT) FOR THE YEAR		73,774	(136,111)	72,972	(136,495)
OTHER COMPREHENSIVE INCOME					
Available-for-sale securities					
fair value changes taken to/(from) equity	29	973	(147)	-	-
fair value changes transferred to income and expenditure account on disposal	29	(4)	(25)	-	-
tax effect	29	(37)	30	-	-
Cash flow hedges					
fair value changes taken to/(from) equity	29	25	(86)	-	-
tax effect	29	(4)	14	-	-
Currency translation difference subsidiary and joint venture	29	2	(9)	-	-
OTHER COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR, NET OF TAX		955	(223)	-	-
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR		74,729	(136,334)	72,972	(136,495)
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR ATTRIBUTABLE TO:					
Owner of the Fund		74,714	(136,354)	72,972	(136,495)
Minority interests		15	20	-	-
		74,729	(136,334)	72,972	(136,495)

The notes on pages 118 to 193 form part of these financial statements.

Exchange Fund – Balance Sheet

as at 31 December 2009

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2009	2008	2009	2008
ASSETS					
Cash and money at call	6	17,736	19,447	17,658	19,383
Placements with banks and other financial institutions	7	112,732	156,529	108,636	153,395
Derivative financial instruments	8(a)	5,565	9,967	4,247	7,729
Financial assets designated at fair value	9	1,995,464	1,347,499	1,995,464	1,347,499
Available-for-sale securities	10	7,678	2,545	493	493
Held-to-maturity securities	11	5,883	5,713	-	-
Loan portfolio	12	43,789	50,760	-	-
Gold	13	572	448	572	448
Other assets	14	15,063	19,578	14,007	17,792
Investments in subsidiaries	15	-	-	4,947	10,145
Interests in associate and joint venture	16	160	158	-	-
Property, plant and equipment	17(a)	812	786	583	584
Operating land lease prepayment	18	2,775	2,849	2,775	2,849
Intangible assets	19	16	15	16	15
TOTAL ASSETS		2,208,245	1,616,294	2,149,398	1,560,332
LIABILITIES AND EQUITY					
Certificates of Indebtedness	20	199,006	176,093	199,006	176,093
Government-issued currency notes and coins in circulation	20	8,427	8,266	8,427	8,266
Balance of the banking system	21	264,567	158,038	264,567	158,038
Derivative financial instruments	8(a)	1,031	4,149	873	3,934
Placements by banks and other financial institutions	22	28,311	13,613	28,311	13,613
Placements by Fiscal Reserves	23	504,123	531,370	504,123	531,370
Placements by Hong Kong Special Administrative Region government funds and statutory bodies	24	41,836	74	41,836	74
Exchange Fund Bills and Notes issued	25	536,429	162,554	536,429	162,554
Other debt securities issued	26	44,459	42,786	-	-
Mortgage-backed securities issued	27	2,021	3,226	-	-
Other liabilities	28	18,753	31,570	12,369	25,905
Total liabilities		1,648,963	1,131,739	1,595,941	1,079,847
Accumulated surplus	29	558,220	484,461	553,457	480,485
Other reserves	29	858	(97)	-	-
Total equity attributable to owner of the Fund		559,078	484,364	553,457	480,485
Minority interests	29	204	191	-	-
Total equity		559,282	484,555	553,457	480,485
TOTAL LIABILITIES AND EQUITY		2,208,245	1,616,294	2,149,398	1,560,332

Norman T.L. Chan

Monetary Authority
1 April 2010

The notes on pages 118 to 193 form part of these financial statements.

Exchange Fund – Statement of Changes in Equity

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2009	2008	2009	2008
Attributable to owner of the Fund					
Accumulated surplus					
At 1 January		484,461	620,592	480,485	616,980
Surplus/(Deficit) for the year	29	73,759	(136,131)	72,972	(136,495)
At 31 December		558,220	484,461	553,457	480,485
Other reserves					
Revaluation reserve					
At 1 January		(88)	126	-	-
Other comprehensive income/(loss) for the year	29	953	(214)	-	-
At 31 December		865	(88)	-	-
Translation reserve					
At 1 January		(9)	-	-	-
Other comprehensive income/(loss) for the year	29	2	(9)	-	-
At 31 December		(7)	(9)	-	-
		858	(97)	-	-
Total equity attributable to owner of the Fund at 31 December		559,078	484,364	553,457	480,485
Minority interests					
At 1 January		191	179	-	-
Total comprehensive income for the year	29	15	20	-	-
Capital injection by minority interests	29	11	-	-	-
Dividends paid to minority interests	29	(13)	(8)	-	-
At 31 December		204	191	-	-
Total equity at 31 December		559,282	484,555	553,457	480,485

The notes on pages 118 to 193 form part of these financial statements.

Exchange Fund – Statement of Cash Flows

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2009	2008	2009	2008
Cash flows from operating activities					
Surplus/(Deficit) before share of profit of associate and joint venture		73,922	(136,078)	72,972	(136,495)
Adjustments for:					
Interest income	4(a)	(22,628)	(37,491)	(21,303)	(35,665)
Dividend income	4(a)	(7,181)	(8,219)	(7,379)	(8,442)
Net gains on available-for-sale securities	4(a)	(20)	(26)	-	-
Interest expense	4(b)	36,063	51,248	35,784	50,138
Depreciation and amortisation	4(c)	140	142	106	110
Elimination of exchange differences and other non-cash items		(976)	2,679	(938)	2,702
Interest received		23,934	38,055	22,590	36,272
Interest paid		(36,063)	(51,273)	(35,811)	(50,201)
Dividends received		7,214	8,187	7,150	8,146
Income tax paid		(64)	(23)	-	-
		74,341	(132,799)	73,171	(133,435)
Change in fair value of derivatives and other debt securities issued		451	(1,237)	390	(1,287)
Change in placements with banks and other financial institutions		(879)	65	(931)	180
Change in financial assets designated at fair value		(592,838)	(142,551)	(592,838)	(142,551)
Change in loan portfolio		7,008	(16,337)	-	-
Change in gold		(124)	(12)	(124)	(12)
Change in other assets		3,181	(470)	2,492	(11)
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		23,074	13,433	23,074	13,433
Change in balance of the banking system		106,529	147,399	106,529	147,399
Change in placements by banks and other financial institutions		14,698	13,613	14,698	13,613
Change in placements by Fiscal Reserves		(27,247)	66,785	(27,247)	66,785
Change in placements by Hong Kong Special Administrative Region government funds and statutory bodies		41,762	44	41,762	44
Change in Exchange Fund Bills and Notes issued		373,875	20,787	373,875	20,787
Change in other liabilities		(12,874)	17,355	(13,509)	17,072
Net cash from/(used in) operating activities		10,957	(13,925)	1,342	2,017

Exchange Fund – Statement of Cash Flows (cont.)

for the year ended 31 December 2009

(Expressed in millions of Hong Kong dollars)	Notes	Group		Fund	
		2009	2008	2009	2008
Cash flows from investing activities					
Loan to a subsidiary		-	-	(2,802)	(8,000)
Loan repayments received from a subsidiary		-	-	8,000	-
(Increase)/Decrease in investment in joint venture		2	(122)	-	-
Proceeds from sale or redemption of available-for-sale securities		1,845	18,566	-	-
Purchase of available-for-sale securities		(5,982)	(17,311)	-	-
Proceeds from redemption of held-to-maturity securities		2,817	3,538	-	-
Purchase of held-to-maturity securities		(2,978)	(3,048)	-	-
Purchase of property, plant and equipment and intangible assets		(95)	(40)	(32)	(27)
Dividends received from subsidiaries		-	-	266	259
Net cash from/(used in) investing activities		(4,391)	1,583	5,432	(7,768)
Cash flows from financing activities					
Proceeds from issue of other debt securities		22,061	24,349	-	-
Redemption of other debt securities issued		(19,652)	(16,343)	-	-
Redemption of mortgage-backed securities issued		(1,172)	(1,055)	-	-
Capital injection by minority interests		11	-	-	-
Dividends paid to minority interests		(13)	(8)	-	-
Net cash from financing activities		1,235	6,943	-	-
Net increase/(decrease) in cash and cash equivalents		7,801	(5,399)	6,774	(5,751)
Cash and cash equivalents at 1 January		199,380	207,487	196,537	204,990
Effect of foreign exchange rate changes		939	(2,708)	938	(2,702)
Cash and cash equivalents at 31 December	30	208,120	199,380	204,249	196,537

The notes on pages 118 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 principal 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. Operating segment information is set out in note 31.

2 SIGNIFICANT ACCOUNTING POLICIES

2.1 Statement of compliance

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

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

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

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

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 (note 2.5.2.2);
- available-for-sale securities (note 2.5.2.5); and
- gold (note 2.10).

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

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

Note 37 contains information about the assumptions relating to fair value estimation of financial instruments. There are no critical accounting judgements involved in the application of the Group's accounting policies except for the valuation of certain financial instruments as set out in note 2.5.3.

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.

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

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

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 and the Group statement of comprehensive income as an allocation of the surplus or deficit and total comprehensive income or loss 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).

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 and any impairment loss relating to the investment. 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).

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

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

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, 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 be 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 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, 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.

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.

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

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

2.5.2.2 Financial assets and financial liabilities designated at fair value

Financial assets and financial liabilities designated at fair value 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 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 or as available-for-sale; and (b) those that meet the definition of loans and receivables.

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

2.5.2.5 Available-for-sale securities

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

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

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

Available-for-sale securities are carried at fair value. Unrealised gains and losses arising from changes in the fair value are recognised in other comprehensive income and accumulated separately in the revaluation reserve, except for impairment losses, if any (note 2.9). Foreign exchange gains and losses on monetary items 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.

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 and other debt securities (other than those which contain embedded derivatives) issued by the Group through the HKMC.

Other financial liabilities 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), the balance of the banking system, placements by Fiscal Reserves and placements by HKSAR government funds and statutory bodies.

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

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

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

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

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

2.5.3 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.

The Group's investments in unlisted investment funds and unlisted equity securities, except for the holding of unlisted shares in the Bank for International Settlements (note 10), are stated at fair value by making reference to valuation reports provided by investment managers. These fair values approximate the net asset values of the investments. The net asset values of the investments are computed based on valuation methods and techniques generally recognised within the industry. The Group regularly assesses the appropriateness of assumptions, methods and techniques applied by the investment managers for determining the most suitable and consistent model for valuation.

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.

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

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

2.5.5 Offsetting

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

2.5.6 Embedded derivatives

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

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

Where the embedded derivative is separated, the host contract is accounted for according to its category (note 2.5.2).

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 at the recalculated effective interest rate 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 in other comprehensive income and accumulated separately in equity. The ineffective portion of any gain or loss is recognised immediately in the income and expenditure account.

Amounts previously recognised in other comprehensive income and 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 in other comprehensive income.

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

2.10 Gold

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

2.11 Property, plant and equipment

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

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

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

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

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 their estimated useful lives as follows:

- Freehold land not depreciated
- Building situated on freehold land 39 years
- Buildings situated on leasehold land 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.

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.

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

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

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 fair value less costs to sell 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 Fiscal Reserves, placements by HKSAR government funds and statutory bodies is payable at a fixed rate determined annually (notes 23 and 24). Interest on these placements is recognised daily in the income and expenditure account on an accrual basis, using the effective interest method.

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

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.

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

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

2.16.2 Net realised and revaluation gains/(losses)

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 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.

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.

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

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

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 or on trading financial instruments, the majority of the exchange gains/(losses) relate to these two categories of financial instruments.

2.18 Related parties

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

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

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

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

2.19 Operating segments

Operating segments are reported in a manner consistent with the internal management reports provided to the chief operating decision maker. The Group comprises the following operating 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 Hong Kong Mortgage Corporation Limited and the Hong Kong Note Printing Limited.

Details of the operating segments of the Group are set out in note 31.

3 CHANGES IN ACCOUNTING POLICIES

The HKICPA has issued certain new and revised HKFRSs that are effective for the current accounting period. There have been no significant changes to the accounting policies applied in these financial statements for the years presented as a result of these developments. However, as a result of adopting HKAS 1 (Revised), Amendments to HKAS 32 and HKAS 1 (Revised), Amendments to HKFRS 7 and HKFRS 8, there are changes to the presentation of these financial statements.

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

3.1 HKAS 1 (Revised), Presentation of Financial Statements

The revised standard separates owner and non-owner changes in equity. The statement of changes in equity includes only details of transactions with owners, with non-owner changes in equity presented in a reconciliation of each component of equity. In addition, the standard introduces the statement of comprehensive income and presents all items of recognised income and expense, either in one single statement, or in two linked statements. The Group has elected to present two statements. The standard also introduced terminology changes to titles for the financial statements. While the Group has changed the “Cash Flow Statement” to “Statement of Cash Flows”, it has elected to retain the titles of “Income and Expenditure Account” and “Balance Sheet”.

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

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

3.2 Amendments to HKAS 32, Financial Instruments: Presentation and HKAS 1 (Revised), Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation

The amendments are related to the classification of certain financial instruments. Puttable financial instruments that represent a residual interest in the net assets of the entity are now classified as equity provided that certain conditions are met. As a result of the adoption of the amendments by the issuers of certain investments held by the Fund, debt securities with carrying value of HK\$26,412 million at 31 December 2008 were reclassified as equity securities (note 9).

3.3 Amendments to HKFRS 7, Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments

The amendments require enhanced disclosures about fair value measurements and liquidity risk. The amendments introduce a three-level hierarchy (note 37(b)) for fair value measurement disclosures about financial instruments and require some specific quantitative disclosures for those instruments classified in the lowest level in the hierarchy. These disclosures will help improve comparability between entities about the effects of fair value measurements. In addition, the amendments clarify and enhance the existing requirements for the disclosure of liquidity risk primarily requiring a separate liquidity risk analysis for derivative and non-derivative financial liabilities. The Group has applied the amendments in 2009. The amendments do not require the provision of comparative figures.

3.4 HKFRS 8, Operating Segments

HKFRS 8 replaces HKAS 14, Segment reporting. It requires a “management approach” under which segment information is presented on the same basis as that used for internal reporting purposes. Operating segments are components of an entity regularly reviewed by an entity’s chief operating decision maker. Items are reported based on internal reporting. As the business segments reported by the Group in accordance with the requirements of HKAS 14 are the same as the operating segments provided to the chief operating decision maker as required by HKFRS 8, there are no changes to the presentation of operating segments and the results of operating segments on the adoption of HKFRS 8.

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

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

4 INCOME AND EXPENDITURE

(a) Investment income/(loss)

	Group		Fund	
	2009	2008	2009	2008
Interest income				
– from derivative financial instruments	293	185	293	185
– from financial assets designated at fair value	20,637	31,721	20,637	31,721
– from other financial assets	1,698	5,585	373	3,759
	22,628	37,491	21,303	35,665
Dividend income				
– from financial assets designated at fair value	7,102	8,162	7,102	8,162
– from other financial assets	79	57	14	14
– from subsidiaries	–	–	263	266
	7,181	8,219	7,379	8,442
Net realised and revaluation gains/(losses)				
– on derivative financial instruments	5,390	(12,984)	6,204	(14,471)
– on financial assets and financial liabilities designated at fair value	67,400	(102,646)	66,573	(101,116)
– on available-for-sale securities	20	26	–	–
	72,810	(115,604)	72,777	(115,587)
Net exchange gains/(losses)	9,762	(12,484)	9,772	(12,440)
Total	112,381	(82,378)	111,231	(83,920)

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

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

(b) Interest expense

	Group		Fund	
	2009	2008	2009	2008
Interest expense on derivative financial instruments	94	–	94	–
Interest expense on Exchange Fund Bills and Notes and other debt securities issued designated at fair value and trading liabilities	1,166	2,725	940	2,326
Interest expense on other financial liabilities	34,803	48,523	34,750	47,812
Total	36,063	51,248	35,784	50,138
Comprises:				
Interest on placements by Fiscal Reserves				
– at a fixed rate determined annually	33,486	46,360	33,486	46,360
– at market-based rates	1	4	1	4
Interest on placements by HKSAR government funds and statutory bodies				
– at a fixed rate determined annually	1,245	–	1,245	–
– at market-based rates	–	2	–	2
Interest on Exchange Fund Bills and Notes issued	940	2,326	940	2,326
Other interest expense	391	2,556	112	1,446
	36,063	51,248	35,784	50,138

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

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

(c) Operating expenses

	Group		Fund	
	2009	2008	2009	2008
Staff costs				
Salaries and other staff costs	785	713	645	584
Retirement benefit costs	57	43	50	36
Premises and equipment expenses				
Depreciation and amortisation	140	142	106	110
Rental expenses under operating leases	37	28	36	28
Other premises expenses	51	45	42	36
General operating costs				
Maintenance of office and computer equipment	46	39	39	33
Financial information and communication services	39	36	34	30
External relations	19	18	17	17
Service fees for financial infrastructure	40	18	40	17
Other professional services	58	43	45	30
Training	6	6	5	5
Others	18	14	21	19
Investment management and custodian fees				
Management and custodian fees	688	752	688	752
Transaction costs	239	268	236	266
Withholding tax	382	481	382	481
Others	17	11	17	11
Total	2,622	2,657	2,403	2,455

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	
	2009	2008
Fixed pay	58.3	58.7
Variable pay	14.5	16.0
Other benefits	6.8	6.5
	79.6	81.2

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

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

HK\$	Group	
	2009	2008
1,500,000 or below	1	1
1,500,001 to 2,000,000	1	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	5	5
4,500,001 to 5,000,000	–	2
5,000,001 to 5,500,000	1	–
6,500,001 to 7,000,000	1	1
7,000,001 to 7,500,000	1	2
7,500,001 to 8,000,000	1	–
10,000,001 to 10,500,000	1	–
11,500,001 to 12,000,000	–	1
	17	17

(d) Note and coin expenses

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

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

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

5 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

	Notes	Total	Trading financial instruments (including hedging instruments)	Financial assets and financial liabilities designated at fair value	Group – 2009			
					Loans and receivables	Held-to- maturity securities	Available- for-sale securities	Other financial liabilities
Cash and money at call	6	17,736	-	-	17,736	-	-	-
Placements with banks and other financial institutions	7	112,732	-	-	112,732	-	-	-
Derivative financial instruments	8(a)	5,565	5,565	-	-	-	-	-
Financial assets designated at fair value	9	1,995,464	-	1,995,464	-	-	-	-
Available-for-sale securities	10	7,678	-	-	-	-	7,678	-
Held-to-maturity securities	11	5,883	-	-	-	5,883	-	-
Loan portfolio	12	43,789	-	-	43,789	-	-	-
Other assets	14	15,063	-	-	15,063	-	-	-
Financial assets		2,203,910	5,565	1,995,464	189,320	5,883	7,678	-
Certificates of Indebtedness	20	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	20	8,427	-	-	-	-	-	8,427
Balance of the banking system	21	264,567	-	-	-	-	-	264,567
Derivative financial instruments	8(a)	1,031	1,031	-	-	-	-	-
Placements by banks and other financial institutions	22	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	23	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	24	41,836	-	-	-	-	-	41,836
Exchange Fund Bills and Notes issued	25	536,429	-	536,429	-	-	-	-
Other debt securities issued	26	44,459	-	2,846	-	-	-	41,613
Mortgage-backed securities issued	27	2,021	-	-	-	-	-	2,021
Other liabilities	28	18,753	-	-	-	-	-	18,753
Financial liabilities		1,648,963	1,031	539,275	-	-	-	1,108,657

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

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

	Notes	Total	Trading financial instruments (including hedging instruments)	Financial assets and financial liabilities designated at fair value	Group – 2008			
					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	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 Fiscal Reserves	23	531,370	-	-	-	-	-	531,370
Placements by HKSAR government funds and statutory bodies	24	74	-	-	-	-	-	74
Exchange Fund Bills and Notes issued	25	162,554	-	162,554	-	-	-	-
Other debt securities issued	26	42,786	-	4,713	-	-	-	38,073
Mortgage-backed securities issued	27	3,226	-	-	-	-	-	3,226
Other liabilities	28	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.)

	Notes	Total	Fund - 2009					
			Trading financial instruments	Financial assets and liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	17,658	-	-	17,658	-	-	-
Placements with banks and other financial institutions	7	108,636	-	-	108,636	-	-	-
Derivative financial instruments	8(a)	4,247	4,247	-	-	-	-	-
Financial assets designated at fair value	9	1,995,464	-	1,995,464	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Other assets	14	14,007	-	-	14,007	-	-	-
Financial assets		2,140,505	4,247	1,995,464	140,301	-	493	-
Certificates of Indebtedness	20	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	20	8,427	-	-	-	-	-	8,427
Balance of the banking system	21	264,567	-	-	-	-	-	264,567
Derivative financial instruments	8(a)	873	873	-	-	-	-	-
Placements by banks and other financial institutions	22	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	23	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	24	41,836	-	-	-	-	-	41,836
Exchange Fund Bills and Notes issued	25	536,429	-	536,429	-	-	-	-
Other liabilities	28	12,369	-	-	-	-	-	12,369
Financial liabilities		1,595,941	873	536,429	-	-	-	1,058,639

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	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	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 Fiscal Reserves	23	531,370	-	-	-	-	-	531,370
Placements by HKSAR government funds and statutory bodies	24	74	-	-	-	-	-	74
Exchange Fund Bills and Notes issued	25	162,554	-	162,554	-	-	-	-
Other liabilities	28	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.)

6 CASH AND MONEY AT CALL

	Group		Fund	
	2009	2008	2009	2008
At amortised cost				
Balance with central banks	1,339	1,231	1,339	1,231
Balance with banks	16,397	18,216	16,319	18,152
Total	17,736	19,447	17,658	19,383

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2009	2008	2009	2008
At amortised cost				
Placements in respect of reverse repurchase agreements				
– with central banks	38,795	17,489	38,795	17,489
– with banks and other financial institutions	1,916	6,119	1,916	6,119
Other placements with banks	72,021	132,921	67,925	129,787
Total	112,732	156,529	108,636	153,395

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 financial risk management approaches are outlined in note 36.

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

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

(a) Fair values of derivative financial instruments

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

	Group				Fund			
	2009		2008		2009		2008	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	812	308	1,276	150	685	201	1,059	-
Interest rate futures contracts	6	-	-	-	6	-	-	-
Currency derivatives								
Forward foreign exchange contracts	3,550	483	5,506	3,917	3,550	482	5,504	3,917
Others								
Stock index futures contracts	-	161	1,113	-	-	161	1,113	-
Bond futures contracts	6	6	53	17	6	6	53	17
Bond options contracts	-	23	-	-	-	23	-	-
	4,374	981	7,948	4,084	4,247	873	7,729	3,934
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	1,035	3	1,866	-	-	-	-	-
Currency derivatives								
Currency swap contracts	134	40	124	53	-	-	-	-
	1,169	43	1,990	53	-	-	-	-
Derivatives designated as hedging instruments in cash flow hedges								
Currency derivatives								
Currency swap contracts	22	7	29	12	-	-	-	-
Total	5,565	1,031	9,967	4,149	4,247	873	7,729	3,934

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									
	2009					2008				
	Total	Up to 3 months	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Total	Up to 3 months	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	63,366	3,382	11,171	39,834	8,979	48,418	20,206	8,758	16,209	3,245
Interest rate futures contracts	12,724	601	11,525	598	-	-	-	-	-	-
Currency derivatives										
Forward foreign exchange contracts	161,442	156,198	5,244	-	-	150,129	145,494	4,635	-	-
Others										
Stock index futures contracts	17,029	17,029	-	-	-	53,812	53,812	-	-	-
Bond futures contracts	5,923	5,923	-	-	-	17,913	17,913	-	-	-
Bond options contracts	3,102	3,102	-	-	-	-	-	-	-	-
	263,586	186,235	27,940	40,432	8,979	270,272	237,425	13,393	16,209	3,245
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	31,373	2,968	5,724	18,406	4,275	25,357	3,287	3,502	13,574	4,994
Currency derivatives										
Currency swap contracts	8,629	740	876	7,013	-	4,953	227	-	4,266	460
	40,002	3,708	6,600	25,419	4,275	30,310	3,514	3,502	17,840	5,454
Derivatives designated as hedging instruments in cash flow hedges										
Currency derivatives										
Currency swap contracts	11,761	861	-	10,900	-	14,770	253	-	-	14,517
Total	315,349	190,804	34,540	76,751	13,254	315,352	241,192	16,895	34,049	23,216

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									
	2009					2008				
Total	Up to 3 months	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Total	Up to 3 months	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	42,629	-	-	33,853	8,776	7,550	-	-	4,550	3,000
Interest rate futures contracts	12,724	601	11,525	598	-	-	-	-	-	-
Currency derivatives										
Forward foreign exchange contracts	160,540	155,989	4,551	-	-	140,214	136,717	3,497	-	-
Others										
Stock index futures contracts	17,029	17,029	-	-	-	53,812	53,812	-	-	-
Bond futures contracts	5,923	5,923	-	-	-	17,913	17,913	-	-	-
Bond options contracts	3,102	3,102	-	-	-	-	-	-	-	-
Total	241,947	182,644	16,076	34,451	8,776	219,489	208,442	3,497	4,550	3,000

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group and Fund	
	2009	2008 (restated)
At fair value		
Debt securities		
Treasury bills and commercial paper		
Listed outside Hong Kong	3,324	-
Unlisted	873,782	285,076
Other debt securities		
Listed outside Hong Kong	403,258	416,601
Unlisted	357,240	423,194
Total debt securities	1,637,604	1,124,871
Equity securities		
Listed		
– in Hong Kong	142,939	92,870
– outside Hong Kong	168,180	103,346
Unlisted	46,741	26,412
Total equity securities	357,860	222,628
Total	1,995,464	1,347,499

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	
	2009	2008	2009	2008
Debt securities, at fair value				
Listed				
– in Hong Kong	78	49	–	–
– outside Hong Kong	57	–	–	–
Unlisted	2,452	1,161	–	–
	2,587	1,210	–	–
Equity securities				
Listed in Hong Kong, at fair value	1,026	842	–	–
Unlisted, at cost	493	493	493	493
	1,519	1,335	493	493
Investment funds, at fair value				
Unlisted	3,572	–	–	–
Total	7,678	2,545	493	493

The Group's investment in unlisted equity securities at 31 December 2009 represents a holding of 4,285 shares (2008: 4,285 shares) in the Bank for International Settlements. The nominal value of each share is 5,000 Special Drawing Rights and is 25% paid up (also note 34(a)). Fair value has not been ascertained for these shares as they are not freely transferable.

11 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2009	2008	2009	2008
At amortised cost				
Debt securities				
Listed				
– in Hong Kong	1,167	1,147	–	–
– outside Hong Kong	2,244	1,138	–	–
Unlisted	2,472	3,428	–	–
Total	5,883	5,713	–	–

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

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

12 LOAN PORTFOLIO

	Group		Fund	
	2009	2008	2009	2008
Mortgage loans, at amortised cost	42,736	49,408	-	-
Non-mortgage loans, at amortised cost	1,067	1,403	-	-
Allowance for loan impairment	(14)	(51)	-	-
Total	43,789	50,760	-	-

13 GOLD

	Group and Fund	
	2009	2008
Gold, at market value 66,798 ounces (2008: 66,798 ounces)	572	448

14 OTHER ASSETS

	Group		Fund	
	2009	2008	2009	2008
Interest and dividends receivable	9,996	11,306	9,323	10,616
Unsettled sales and redemption of securities	3,698	6,084	3,698	6,084
Prepayments, receivables and other assets	1,122	1,882	739	815
Staff housing loans	247	277	247	277
Deferred tax assets	-	29	-	-
Total	15,063	19,578	14,007	17,792

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

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

15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2009	2008
Unlisted shares, at cost	2,145	2,145
Loan to a subsidiary	2,802	8,000
Total	4,947	10,145

The following is a list of the principal subsidiaries as at 31 December 2009:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Group'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%
Eight Finance Investment Company Limited	Hong Kong	Investment holding	HK\$1	100%
Bauhinia HKMC Corporation Limited	PRC	Mortgage guarantee business	RMB100,000,000	90%

The HKMC has unissued authorised share capital of HK\$1 billion (2008: HK\$1 billion), which is callable from the Fund.

Loan to the Eight Finance Investment Company Limited at 31 December 2009 is an unsecured, interest-free loan and repayable on demand. The outstanding loan to the HKMC at 31 December 2008 has been fully repaid.

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	
	2009	2008	2009	2008
Associate				
Unlisted shares, at cost	-	-	-	-
Share of net assets	45	45	-	-
	45	45	-	-
Joint venture				
Unlisted shares, at cost	120	120	-	-
Due from a joint venture	-	2	-	-
Share of net assets	2	-	-	-
Currency translation difference	(7)	(9)	-	-
	115	113	-	-
Total	160	158	-	-

Investment in associate comprises unlisted shares of Hong Kong Interbank Clearing Limited directly held by the Fund at a cost of HK\$5,000 (2008: 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 2008	624	639	1,263
Additions	–	31	31
Disposals	–	(4)	(4)
At 31 December 2008	624	666	1,290
At 1 January 2009	624	666	1,290
Additions	–	89	89
Disposals	(3)	(7)	(10)
At 31 December 2009	621	748	1,369
Accumulated depreciation			
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
At 1 January 2009	75	429	504
Charge for the year	14	47	61
Written back on disposal	(1)	(7)	(8)
At 31 December 2009	88	469	557
Net book value			
At 31 December 2009	533	279	812
At 31 December 2008	549	237	786

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 2008	612	209	821
Additions	–	18	18
Disposals	–	(3)	(3)
At 31 December 2008	612	224	836
At 1 January 2009	612	224	836
Additions	–	26	26
Disposals	–	(6)	(6)
At 31 December 2009	612	244	856
Accumulated depreciation			
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
At 1 January 2009	71	181	252
Charge for the year	14	13	27
Written back on disposal	–	(6)	(6)
At 31 December 2009	85	188	273
Net book value			
At 31 December 2009	527	56	583
At 31 December 2008	541	43	584

(b) The net book value of premises comprises:

	Group		Fund	
	2009	2008	2009	2008
In Hong Kong				
Buildings situated on land held on medium-term leases (between 10 and 50 years)	510	525	504	517
Outside Hong Kong				
Freehold land and the building situated thereon	23	24	23	24
Total	533	549	527	541

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	
	2009	2008
Cost		
At 1 January and 31 December	3,231	3,231
Accumulated amortisation		
At 1 January	382	308
Charge for the year	74	74
At 31 December	456	382
Net book value		
At 31 December	2,775	2,849

19 INTANGIBLE ASSETS

	Group and Fund	
	Computer software licences and system development costs	
	2009	2008
Cost		
At 1 January	246	237
Additions	6	9
At 31 December	252	246
Accumulated amortisation		
At 1 January	231	224
Charge for the year	5	7
At 31 December	236	231
Net book value		
At 31 December	16	15

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	
	2009	2008	2009	2008
Carrying amount	199,006	176,093	8,427	8,266
Reconciliation with face value:				
Hong Kong dollar face value	HK\$200,185	HK\$177,225	HK\$8,477	HK\$8,319
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\$25,665	US\$22,721	US\$1,087	US\$1,067
Market exchange rate for translation into Hong Kong dollars	US\$1 = HK\$7.75405	US\$1 = HK\$7.7502	US\$1 = HK\$7.75405	US\$1 = HK\$7.7502
Carrying amount	HK\$199,006	HK\$176,093	HK\$8,427	HK\$8,266

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	
	2009	2008
At amortised cost		
Placements by banks	28,311	13,613

23 PLACEMENTS BY FISCAL RESERVES

	Group and Fund	
	2009	2008
Placements with interest payable at a fixed rate determined annually		
General Revenue Account	269,867	275,773
Land Fund	175,846	164,650
Capital Works Reserve Fund	22,026	56,062
Civil Service Pension Reserve Fund	21,631	20,254
Disaster Relief Fund	22	38
Innovation and Technology Fund	3,971	4,298
Lotteries Fund	7,832	7,033
Capital Investment Fund	820	1,301
Loan Fund	1,821	1,644
	503,836	531,053
Placements with interest payable at market-based rates		
General Revenue Account	276	253
Loan Fund	-	19
Capital Works Reserve Fund	11	45
	287	317
Total	504,123	531,370

Interest on the majority of the placements by Fiscal Reserves is payable at a fixed rate determined every January. The rate is the average annual 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 subject to a minimum of zero percent, whichever is the higher. This rate has been fixed at 6.3% per annum for 2010 and 6.8% for 2009 (2008: 9.4%).

Placements by Fiscal Reserves are not permanently appropriated for the use of the Fund, and the majority is repayable on demand.

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

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

24 PLACEMENTS BY HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT FUNDS AND STATUTORY BODIES

	Group and Fund	
	2009	2008
Placements with interest payable at a fixed rate determined annually		
Research Endowment Fund	15,805	–
Bond Fund	5,631	–
Housing Authority	20,339	–
	41,775	–
Placements with interest payable at market-based rates		
Deposit Protection Scheme Fund	61	74
Total	41,836	74

The fixed rate arrangement related to the placements by Fiscal Reserves is also applied to certain HKSAR government funds and statutory bodies. This rate has been fixed at 6.3% per annum for 2010 and 6.8% for 2009.

25 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group and Fund	
	2009	2008
At fair value		
Exchange Fund Bills and Notes issued		
Exchange Fund Bills	464,304	90,745
Exchange Fund Notes	73,125	72,809
	537,429	163,554
Exchange Fund Bills held	(1,000)	(1,000)
Total	536,429	162,554

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

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

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 2009, there was no short position in EFBN (2008: Nil).

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

	Group and Fund			
	2009		2008	
	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Issued by Currency Board Operations segment				
Redemption amount at 1 January	90,753	66,900	76,612	64,300
Issuance	1,031,328	16,400	261,387	16,400
Redemption	(657,719)	(13,600)	(247,246)	(13,800)
Redemption amount at 31 December	464,362	69,700	90,753	66,900
Long positions held by Financial Stability and Other Activities segment				
Redemption amount at 31 December	(1,000)	–	(1,000)	–
Total redemption amount	463,362	69,700	89,753	66,900
Carrying amount, at fair value	463,304	73,125	89,745	72,809
Difference	58	(3,425)	8	(5,909)

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.)

26 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2009	2008	2009	2008
Debt securities issued, carried at amortised cost				
Notes	4,218	8,211	-	-
Debt securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk				
Notes	37,395	29,862	-	-
	41,613	38,073	-	-
Debt securities issued, designated at fair value				
Notes	2,846	4,713	-	-
Total	44,459	42,786	-	-

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	
	2009	2008	2009	2008
Total debt securities issued				
Redemption amount at 1 January	40,939	32,938	-	-
Issuance	22,689	24,378	-	-
Redemption	(19,652)	(16,343)	-	-
Exchange difference	13	(34)	-	-
Redemption amount at 31 December	43,989	40,939	-	-
Carrying amount	44,459	42,786	-	-
Difference	(470)	(1,847)	-	-
Debt securities issued, designated at fair value				
Redemption amount	3,427	4,703	-	-
Carrying amount, at fair value	2,846	4,713	-	-
Difference	581	(10)	-	-

The fair value changes of debt securities issued designated at fair value 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.)

27 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2009	2008	2009	2008
Mortgage-backed securities issued, carried at amortised cost	1,051	1,258	-	-
Mortgage-backed securities hedged under fair value hedges where carrying amount is adjusted for changes in value resulting from the hedged risk	970	1,968	-	-
Total	2,021	3,226	-	-

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	
	2009	2008	2009	2008
Total mortgage-backed securities issued				
Redemption amount at 1 January	3,148	4,203	-	-
Redemption	(1,172)	(1,055)	-	-
Redemption amount at 31 December	1,976	3,148	-	-
Carrying amount	2,021	3,226	-	-
Difference	(45)	(78)	-	-

28 OTHER LIABILITIES

	Group		Fund	
	2009	2008	2009	2008
Unsettled purchases of securities	11,428	24,900	11,428	24,900
Accrued charges and other liabilities	6,321	5,723	568	605
Interest payable	819	865	373	400
Tax payable	138	53	-	-
Deferred tax liabilities	47	29	-	-
Total	18,753	31,570	12,369	25,905

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

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

29 EQUITY

	Group		Fund	
	2009	2008	2009	2008
Attributable to owner of the Fund				
Accumulated surplus				
At 1 January	484,461	620,592	480,485	616,980
Surplus/(Deficit) for the year	73,759	(136,131)	72,972	(136,495)
At 31 December	558,220	484,461	553,457	480,485
Other reserves				
Revaluation reserve				
At 1 January	(88)	126	-	-
Fair value changes on available-for-sale securities				
– revaluation	973	(147)	-	-
– realisation on disposal	(4)	(25)	-	-
– tax effect	(37)	30	-	-
Cash flow hedges				
– revaluation	25	(86)	-	-
– tax effect	(4)	14	-	-
At 31 December	865	(88)	-	-
Translation reserve				
At 1 January	(9)	-	-	-
Currency translation difference				
– subsidiary and joint venture	2	(9)	-	-
At 31 December	(7)	(9)	-	-
	858	(97)	-	-
	559,078	484,364	553,457	480,485
Minority interests				
At 1 January	191	179	-	-
Total comprehensive income for the year	15	20	-	-
Capital injection by minority interests	11	-	-	-
Dividends paid to minority interests	(13)	(8)	-	-
At 31 December	204	191	-	-
Total	559,282	484,555	553,457	480,485

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

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

30 NOTES TO THE STATEMENT OF CASH FLOWS

Analysis of cash and cash equivalents in the statement of cash flows

	Group		Fund	
	2009	2008	2009	2008
Cash and money at call	17,736	19,447	17,658	19,383
Placements with banks and other financial institutions	110,898	155,574	107,105	152,795
Treasury bills and commercial paper	79,486	24,359	79,486	24,359
Total	208,120	199,380	204,249	196,537

Reconciliation with the balance sheet

	Notes	Group		Fund	
		2009	2008	2009	2008
Amounts shown in the balance sheet					
Cash and money at call	6	17,736	19,447	17,658	19,383
Placements with banks and other financial institutions	7	112,732	156,529	108,636	153,395
Financial assets designated at fair value					
Treasury bills and commercial paper	9	877,106	285,076	877,106	285,076
		1,007,574	461,052	1,003,400	457,854
Less: Amounts with original maturity beyond 3 months		(799,454)	(261,672)	(799,151)	(261,317)
Cash and cash equivalents in the statement of cash flows		208,120	199,380	204,249	196,537

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

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

31 OPERATING SEGMENT INFORMATION

The Group determines its operating segments based on the reports reviewed by the chief operating decision maker. As a central banking institution, the HKMA is responsible for managing the Exchange Fund, maintaining the monetary and banking stability of Hong Kong. The Group comprises operating segments as stated in note 2.19.

	Group									
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Total	
	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Income/(Loss)	(1,441)	22,897	112,404	(107,379)	110,963	(84,482)	1,940	2,574	112,903	(81,908)
Expenditure										
Interest expense	940	2,325	34,844	47,810	35,784	50,135	279	1,113	36,063	51,248
Other expenses (note 31(b))	-	-	-	-	1,447	1,637	1,471	1,285	2,918	2,922
	940	2,325	34,844	47,810	37,231	51,772	1,750	2,398	38,981	54,170
Surplus/(Deficit) before share of profit of associate and joint venture	(2,381)	20,572	77,560	(155,189)	73,732	(136,254)	190	176	73,922	(136,078)
Share of profit of associate and joint venture	-	-	-	-	-	-	2	2	2	2
Surplus/(Deficit) before taxation	(2,381)	20,572	77,560	(155,189)	73,732	(136,254)	192	178	73,924	(136,076)
Income tax	-	-	-	-	-	-	(150)	(35)	(150)	(35)
Surplus/(Deficit) for the year	(2,381)	20,572	77,560	(155,189)	73,732	(136,254)	42	143	73,774	(136,111)
Attributable to:										
Owner of the Fund	(2,381)	20,572	77,560	(155,189)	73,732	(136,254)	27	123	73,759	(136,131)
Minority interests	-	-	-	-	-	-	15	20	15	20
	(2,381)	20,572	77,560	(155,189)	73,732	(136,254)	42	143	73,774	(136,111)

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

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

	Group											
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Re-allocation (note 31(c) & (d))		Total	
	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Assets												
Backing Assets												
Investment in designated US dollar assets	1,079,351	566,950	-	-	1,079,351	566,950	-	-	-	-	1,079,351	566,950
Interest receivable on designated US dollar assets	1,738	1,976	-	-	1,738	1,976	-	-	-	-	1,738	1,976
Net accounts payable	-	(14,328)	-	-	-	(14,328)	-	-	-	14,328	-	-
Other investments	-	-	1,043,672	946,096	1,043,672	946,096	61,991	71,054	(1,000)	(1,000)	1,104,663	1,016,150
Other assets	-	-	15,742	22,238	15,742	22,238	6,279	8,022	472	958	22,493	31,218
Total assets	1,081,089	554,598	1,059,414	968,334	2,140,503	1,522,932	68,270	79,076	(528)	14,286	2,208,245	1,616,294
Liabilities												
Monetary Base												
Certificates of Indebtedness	199,006	176,093	-	-	199,006	176,093	-	-	-	-	199,006	176,093
Government-issued currency notes and coins in circulation	8,427	8,266	-	-	8,427	8,266	-	-	-	-	8,427	8,266
Balance of the banking system	264,567	158,038	-	-	264,567	158,038	-	-	-	-	264,567	158,038
Exchange Fund Bills and Notes issued	537,429	163,554	-	-	537,429	163,554	-	-	(1,000)	(1,000)	536,429	162,554
Interest payable on Exchange Fund Notes	373	398	-	-	373	398	-	-	-	-	373	398
Net accounts (receivable)/payable	(336)	(958)	-	-	(336)	(958)	-	-	472	958	136	-
Other debt securities issued	-	-	-	-	-	-	44,459	42,786	-	-	44,459	42,786
Mortgage-backed securities issued	-	-	-	-	-	-	2,021	3,226	-	-	2,021	3,226
Placements by banks and other financial institutions	-	-	28,311	13,613	28,311	13,613	-	-	-	-	28,311	13,613
Placements by Fiscal Reserves	-	-	504,123	531,370	504,123	531,370	-	-	-	-	504,123	531,370
Placements by HKSAR government funds and statutory bodies	-	-	41,775	-	41,775	-	61	74	-	-	41,836	74
Other liabilities	-	-	12,615	14,999	12,615	14,999	6,660	5,994	-	14,328	19,275	35,321
Total liabilities	1,009,466	505,391	586,824	559,982	1,596,290	1,065,373	53,201	52,080	(528)	14,286	1,648,963	1,131,739

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

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

	Group											
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Re-allocation (note 31(c) & (d))		Total	
	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Accumulated surplus												
At 1 January	49,207	37,213	408,352	559,482	457,559	596,695	26,902	23,897	-	-	484,461	620,592
Surplus/(Deficit) for the year attributable to owner of the Fund	(2,381)	20,572	77,560	(155,189)	73,732	(136,254)	27	123	-	-	73,759	(136,131)
Transfer between Currency Board Operations and general reserves (note 31(e))	24,797	(8,578)	(14,065)	4,059	12,179	(2,882)	(12,179)	2,882	-	-	-	-
At 31 December	71,623	49,207	471,847	408,352	543,470	457,559	14,750	26,902	-	-	558,220	484,461
Other reserves	-	-	743	-	743	-	115	(97)	-	-	858	(97)
Minority interests	-	-	-	-	-	-	204	191	-	-	204	191
Total equity	71,623	49,207	472,590	408,352	544,213	457,559	15,069	26,996	-	-	559,282	484,555
Total liabilities and equity	1,081,089	554,598	1,059,414	968,334	2,140,503	1,522,932	68,270	79,076	(528)	14,286	2,208,245	1,616,294

(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 issued. 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 2009, deduction from the Backing Assets comprises:

- “other liabilities” of Nil (2008: HK\$14,328 million) – 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 2009, deductions from the Monetary Base comprise:

- “other assets” of HK\$472 million (2008: HK\$958 million) – As Hong Kong dollar interest rate swaps have been used as a means to manage the cost of issuing Exchange Fund Notes, interest receivable of HK\$19 million (2008: HK\$11 million) and revaluation gains of HK\$453 million (2008: HK\$947 million) on these interest rate swaps are included in “net accounts (receivable)/payable” to reduce the Monetary Base.

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

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

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

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

32 PLEDGED ASSETS

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

	Notes	Group		Fund	
		2009	2008	2009	2008
Secured liabilities					
Stock index futures contracts – notional amount	8(b)	17,029	53,812	17,029	53,812
Bond futures contracts – notional amount	8(b)	5,923	17,913	5,923	17,913
Interest rate futures contracts – notional amount	8(b)	12,724	–	12,724	–
Mortgage-backed securities issued	27	2,021	3,226	–	–
Assets pledged					
Financial assets designated at fair value		2,457	8,884	2,457	8,884
Held-to-maturity securities		–	445	–	–
Placements with banks		34	36	–	–
Mortgage loans		1,906	2,622	–	–

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

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

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

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

33 COMMITMENTS

(a) Capital commitments

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

	Group		Fund	
	2009	2008	2009	2008
Contracted for	8	48	8	6
Authorised but not yet contracted for	161	189	136	159
	169	237	144	165

(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 2009, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$4,133 million equivalent (2008: HK\$4,059 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2009, there was no outstanding balance due from the IMF under this NAB facility (2008: 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 (2008: 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 2009, there was no outstanding balance due from the HKDPB under this facility (2008: Nil).

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

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

(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 (2008: HK\$30 billion) at prevailing market interest rates. As at 31 December 2009, there was no outstanding balance due from the HKMC under this facility (2008: HK\$8 billion) (note 15).

(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\$44,586 million equivalent (2008: HK\$44,564 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2009, there was no outstanding transaction with any central bank under this arrangement (2008: Nil).

(f) Investment commitments

The Group's subsidiary, the Eight Finance Investment Company Limited, had investment commitments of HK\$9,351 million at 31 December 2009 (2008: Nil).

(g) Lease commitments

At 31 December 2009, the total future minimum lease payments under non-cancellable operating leases of premises were payable as follows:

	Group		Fund	
	2009	2008	2009	2008
Not later than one year	37	32	35	32
Later than one year and not later than five years	64	97	64	97
Later than five years	-	2	-	2
Total	101	131	99	131

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

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

34 CONTINGENT LIABILITIES

- (a) At 31 December 2009, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$195 million equivalent (2008: 16.1 million Special Drawing Rights or HK\$192 million equivalent), in respect of the uncalled portion of its 4,285 shares (2008: 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. This guarantee has not been triggered as of 31 December 2009. The Financial Secretary does not expect that the arrangement will need to be triggered, since the Hong Kong banking sector is fundamentally sound. The guarantee is valid until the end of 2010.

35 MATERIAL RELATED PARTY TRANSACTIONS

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

In addition to the transactions and balances disclosed elsewhere in these financial statements, during the year, the Group, through the HKMC, purchased HK\$173 million (2008: HK\$71 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 the EFAC and its Sub-Committees are appointed in a personal capacity by the Financial Secretary for the expertise and experience that they can bring to the Committees. It is not appropriate to disclose details of transactions with companies related to Committee members as all such transactions have been conducted as a normal part of the operation of the Group and on terms consistent with its ongoing operations.

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

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

36 FINANCIAL RISK MANAGEMENT

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

36.1 Governance

The Financial Secretary is advised by the EFAC in his control of the Fund. The 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 the 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 include knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

The 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 the 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 the 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.)

36.2 Investment management and control

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

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

	2009 and 2008
Asset type	
Bonds	75%
Equities and related investments	25%
	100%
Currency	
US dollar and other currencies ¹	86%
Euro, yen, sterling and other currencies ²	14%
	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, the 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 the 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. The RMC monitors the risk exposure of the Fund, checks compliance of investment activities against established guidelines and reports and follows up any identified breaches.

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

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

36.3 Credit risk

Credit risk is the risk of financial loss when a counterparty or a borrower fails to meet its contractual obligations. It arises principally from the investments of the Fund.

36.3.1 Management of credit risk

The HKMA maintains effective credit risk management over the investments of the Fund. Based on the delegated authority of the 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 the 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.

As an on-going effort to strengthen the credit risk management system of the HKMA to be in line with best market practices, refinements have been introduced in 2009 to the methodology by making reference to an expanded set of factors in assessing the credit-worthiness of the HKMA's counterparties and determining their credit limits. 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 be qualified 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 the 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 the EFAC, and are followed up by the RMC in a timely manner. The approval authorities to sanction these breaches are set out in the Credit Exposure Policy.

To manage the exposure to credit risk arising from the loan portfolio and mortgage insurance business, a four-pronged approach is established for (i) selecting Approved Sellers carefully, (ii) adopting prudent mortgage purchasing criteria and insurance eligibility criteria, (iii) conducting effective due diligence reviews and (iv) ensuring adequate protection for higher-risk mortgages.

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

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

36.3.2 Exposure to credit risk

The use of the Fund to guarantee the repayment of all customer deposits held with all authorized institutions in Hong Kong (note 34(b)) gives rise to credit risk. This guarantee has not been triggered as of 31 December 2009. 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 into account any collateral held or other credit enhancements is shown below:

	Notes	Group		Fund	
		2009	2008 (restated)	2009	2008 (restated)
Cash and money at call	6	17,736	19,447	17,658	19,383
Placements with banks and other financial institutions	7	112,732	156,529	108,636	153,395
Derivative financial instruments	8(a)	5,565	9,967	4,247	7,729
Debt securities designated at fair value	9	1,637,604	1,124,871	1,637,604	1,124,871
Available-for-sale debt securities	10	2,587	1,210	–	–
Held-to-maturity securities	11	5,883	5,713	–	–
Loan portfolio	12	43,789	50,760	–	–
Other assets		15,063	19,549	14,007	17,792
Loan to a subsidiary	15	–	–	2,802	8,000
Due from a joint venture	16	–	2	–	–
Mortgage insurance risk in force	36.6	14,921	9,831	–	–
Loan commitments and other credit related commitments		88,719	88,623	118,719	110,623
Total		1,944,599	1,486,502	1,903,673	1,441,793

The loan portfolio is secured by mortgages on properties. Reserve funds and deferred considerations are also used as an additional form of credit enhancement.

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

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

36.3.3 Credit quality

The Group predominantly invests in liquid Organisation for Economic Co-operation and Development (OECD) government bonds and other quasi-government debt securities issues. As at 31 December 2009, approximately 95% (2008: 96%) 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	
	2009	2008 (restated)	2009	2008 (restated)
Cash and money at call, placements with banks and other financial institutions, by credit rating¹				
AAA	40,107	19,446	40,107	19,446
AA- to AA +	32,035	95,842	28,083	93,861
A- to A +	57,411	59,754	57,191	58,538
Lower than A- (including un-rated risk)	915	934	913	933
	130,468	175,976	126,294	172,778
Debt securities, by credit rating¹				
AAA	1,563,347	1,087,389	1,562,078	1,086,784
AA- to AA +	28,629	27,099	22,273	21,330
A- to A +	5,561	3,732	4,716	3,183
Lower than A- (including un-rated risk)	48,537	13,574	48,537	13,574
	1,646,074	1,131,794	1,637,604	1,124,871
Loan portfolio				
Neither past due nor impaired (note (a))	42,855	49,761	-	-
Past due but not impaired (note (b))	943	1,027	-	-
Impaired (note (c))	5	23	-	-
Allowance for loan impairment	(14)	(51)	-	-
	43,789	50,760	-	-
Total	1,820,331	1,358,530	1,763,898	1,297,649

¹ The lower of ratings designated by rating agencies Moody’s and Standard and Poor’s.

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

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

(a) Loans that are neither past due nor impaired

An internal rating system is used for assessing the credit quality of the loan portfolio. Grades 1 to 5 are loans that are neither past due nor impaired. Grades 1 to 3 include loans with no past due experience and with different level of credit enhancement in addition to the collateral. Grade 4 includes loans with past due experience and credit enhancement in addition to the collateral. Grade 5 includes loans with past due experience and collateral but without further credit enhancement. The following analysis shows the credit quality of loans that were neither past due nor impaired at the balance sheet date:

	Group		Fund	
	2009	2008	2009	2008
Grades				
1 to 3	42,794	49,726	-	-
4	-	2	-	-
5	61	33	-	-
Total	42,855	49,761	-	-

(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	
	2009	2008	2009	2008
Loans that were past due				
90 days or less	933	1,021	-	-
91 – 180 days	5	4	-	-
over 180 days	5	2	-	-
Total	943	1,027	-	-
Fair value of collateral and other credit enhancements	2,753	2,174	-	-

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 2009, the fair value of related collateral held and credit enhancement was HK\$9 million (2008: HK\$27 million).

36.3.4 Concentration of credit risk

The Group has no significant concentration of credit risk. Credit risk of the Group is spread over a large number of counterparties and countries. The following table analyses the maximum credit risk exposure (note 36.3.2) by industry groups:

	Group		Fund	
	2009	2008 (restated)	2009	2008 (restated)
Governments and government agencies ¹	1,631,417	1,127,900	1,631,104	1,127,556
Supra-nationals	42,012	44,674	41,967	44,576
States, provinces and public-sector entities ²	41,764	41,636	70,913	70,815
Financial institutions	103,125	172,362	92,559	164,339
Others	126,281	99,930	67,130	34,507
Total	1,944,599	1,486,502	1,903,673	1,441,793

¹ Including debt securities guaranteed by governments.

² Including debt securities guaranteed by states.

36.4 Market risk

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

36.4.1 Types of market risk

(a) Interest rate risk

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

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.

The majority of the equity securities held by the Group are constituent stocks of major stock market indexes and companies with large market capitalisation.

36.4.2 Management of market risk

The market risk of the Fund as a whole is regularly measured and monitored to prevent excessive risk exposure. The investment benchmark and tactical deviation limits of the Fund govern the asset allocation strategies. This, together with the volatility of asset markets, will affect the Fund's market risk exposure. The Fund uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies. The market risk of the Fund is mainly measured and monitored using the Value-at-Risk (VaR) methodology.

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 the RMC and reported to management, the ISC and the 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 the EFAC to ensure that the market risk exposure of the Fund is within its limit. 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 the ISC and the 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 the ISC and the EFAC on a regular basis.

In addition, to manage the interest rate risk arising from the fixed-rate debt securities issued by the Group to fund the purchase of portfolios of loans, a major portion of the risk is hedged using fair value hedges in the form of interest rate swaps by swapping into floating-rate funding to better match the floating-rate assets.

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

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

36.4.3 Exposure to market risk

(a) Interest rate risk

The following tables show the interest rate gap position in respect of the Group's major interest bearing assets and liabilities, including the net repricing effect of interest rate derivatives. The assets and liabilities are stated at carrying amounts and categorised by the earlier of contractual repricing dates or maturity dates.

	Group – 2009 Repricing period						Interest bearing total	Non-interest bearing
	Up to 1 month	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years		
Assets								
Cash and money at call	17,635	-	-	-	-	-	17,635	101
Placements with banks and other financial institutions	111,509	1,135	69	-	-	-	112,713	19
Financial assets designated at fair value	138,840	268,546	553,705	307,874	215,276	149,793	1,634,034	361,430
Available-for-sale securities	1,201	931	455	-	-	-	2,587	5,091
Held-to-maturity securities	502	1,000	763	3,142	476	-	5,883	-
Loan portfolio	36,615	6,978	124	57	15	-	43,789	-
Interest-bearing assets	306,302	278,590	555,116	311,073	215,767	149,793	1,816,641	
Liabilities								
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311	-
Placements by Fiscal Reserves with interest payable at market-based rates ¹	287	-	-	-	-	-	287	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	61	-	-	-	-	-	61	-
Exchange Fund Bills and Notes issued	89,312	268,167	122,334	45,203	8,257	3,156	536,429	-
Other debt securities issued	6,043	6,294	6,658	19,659	4,003	1,802	44,459	-
Mortgage-backed securities issued	1,051	-	229	741	-	-	2,021	-
Interest-bearing liabilities	125,065	274,461	129,221	65,603	12,260	4,958	611,568	
Interest rate derivatives (net position, notional amounts)	(13,406)	11,476	2,617	(6,976)	3,983	2,400	94	
Interest rate sensitivity gap	167,831	15,605	428,512	238,494	207,490	147,235	1,205,167	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies 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 (notes 23 and 24). The fixed rate is determined every January. As at 31 December 2009, such placements amounted to HK\$545,611 million (2008: HK\$531,053 million).

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

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

	Group – 2008 Repricing period						Interest bearing total	Non-interest bearing
	Up to 1 month	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years		
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	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 Fiscal Reserves with interest payable at market-based rates ¹	317	-	-	-	-	-	317	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	74	-	-	-	-	-	74	-
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	37,113	60,990	42,888	62,509	14,437	4,633	222,570	
Interest rate derivatives (net position, notional amounts)	(16,563)	(16,273)	6,172	18,524	5,238	2,902	-	
Interest rate sensitivity gap	198,285	18,162	248,983	308,822	195,481	162,812	1,132,545	

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

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

	Fund – 2009							Interest bearing total	Non-interest bearing
	Repricing period								
	Up to 1 month	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years			
Assets									
Cash and money at call	17,603	-	-	-	-	-	17,603	55	
Placements with banks and other financial institutions	107,860	776	-	-	-	-	108,636	-	
Financial assets designated at fair value	138,840	268,546	553,705	307,874	215,276	149,793	1,634,034	361,430	
Interest-bearing assets	264,303	269,322	553,705	307,874	215,276	149,793	1,760,273		
Liabilities									
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311	-	
Placements by Fiscal Reserves with interest payable at market-based rates ¹	287	-	-	-	-	-	287	-	
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	61	-	-	-	-	-	61	-	
Exchange Fund Bills and Notes issued	89,312	268,167	122,334	45,203	8,257	3,156	536,429	-	
Interest-bearing liabilities	117,971	268,167	122,334	45,203	8,257	3,156	565,088		
Interest rate derivatives (net position, notional amounts)	-	24,930	(99)	(25,853)	(1,378)	2,400	-		
Interest rate sensitivity gap	146,332	26,085	431,272	236,818	205,641	149,037	1,195,185		

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

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

	Fund – 2008 Repricing period							Interest bearing total	Non-interest bearing
	Up to 1 month	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years			
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	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 Fiscal Reserves with interest payable at market-based rates ¹	317	-	-	-	-	-	317	-	
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	74	-	-	-	-	-	74	-	
Exchange Fund Bills and Notes issued	15,647	51,871	36,106	46,590	9,918	2,422	162,554	-	
Interest-bearing liabilities	25,776	55,746	36,106	46,590	9,918	2,422	176,558		
Interest rate derivatives (net position, notional amounts)	-	(7,550)	-	4,550	1,800	1,200	-		
Interest rate sensitivity gap	187,733	14,418	247,892	308,188	196,168	163,321	1,117,720		

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			
	2009		2008	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
Hong Kong dollar	187.5	1,418.5	134.5	908.9
US dollar and other currencies ¹	1,785.6	227.5	1,265.9	218.2
	1,973.1	1,646.0	1,400.4	1,127.1
Euro, yen, sterling and other currencies ²	235.2	3.0	215.9	4.6
Total	2,208.3	1,649.0	1,616.3	1,131.7

	Fund			
	2009		2008	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
Hong Kong dollar	150.2	1,376.0	99.5	862.4
US dollar and other currencies ¹	1,765.2	217.4	1,245.5	213.2
	1,915.4	1,593.4	1,345.0	1,075.6
Euro, yen, sterling and other currencies ²	234.0	2.5	215.3	4.2
Total	2,149.4	1,595.9	1,560.3	1,079.8

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 2009 and 2008, the majority of equity investments are reported as “financial assets designated at fair value” as shown in note 9.

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

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

36.4.4 Sensitivity analysis

The VaR positions of the Fund at 31 December and during the year, based on a 95% confidence level and one-month time horizon, were as follows:

	Fund	
	2009	2008
VaR		
At 31 December	30,324	63,979
During the year		
Average	41,435	42,515
Maximum	64,131	70,987
Minimum	30,324	28,101

36.5 Liquidity risk

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

36.5.1 Management of liquidity risk

To ensure sufficient liquidity to meet liabilities and the ability to raise funds to meet exceptional needs, the Group invests primarily in liquid financial markets and instruments that are readily saleable to meet liquidity needs. There are internal investment restrictions to prevent undue concentrations in individual debt securities issues, debt securities issuers, and groups of closely related debt securities issuers. Such restrictions are derived based on various factors such as the nature or maturity of the securities. There are also limitations on the maximum proportion of assets that can be placed in fixed term deposits, and requirements regarding the ability to convert foreign currency assets into cash. All these restrictions and limits are designed to promote the liquidity of assets and consequently minimise the liquidity risk. Compliance with these limits is monitored by the RMC and any breaches are reported to the ISC and the EFAC and are promptly followed up.

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

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

36.5.2 Exposure to liquidity risk

The following tables show the remaining contractual maturities at the balance sheet date of major financial liabilities, commitments and derivative financial liabilities, which are based on contractual undiscounted cash flows and the earliest date on which the Group can be required to pay.

	Group – 2009						Total
	Remaining maturity						
	Up to 1 month or on demand	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
Certificates of Indebtedness	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	8,427	-	-	-	-	-	8,427
Balance of the banking system	264,567	-	-	-	-	-	264,567
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	6,836	-	-	-	35,000	-	41,836
Exchange Fund Bills and Notes issued	89,311	268,625	123,823	46,712	8,825	3,344	540,640
Other debt securities issued	1,119	3,715	7,910	28,055	4,604	2,896	48,299
Mortgage-backed securities issued	49	30	402	1,612	-	-	2,093
Other liabilities	17,421	243	223	-	-	-	17,887
Loan commitments and other credit related commitments	88,719	-	-	-	-	-	88,719
Total	1,207,889	272,613	132,358	76,379	48,429	6,240	1,743,908
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- On net basis	179	(10)	102	66	176	54	567
- On gross basis							
Total outflows	24,128	7,053	8,768	15,798	614	-	56,361
Total inflows	(23,714)	(7,010)	(8,741)	(15,793)	(608)	-	(55,866)
Total	593	33	129	71	182	54	1,062

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

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

	Group – 2008						Total
	Remaining maturity						
	Up to 1 month or on demand	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
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 Fiscal Reserves	531,370	-	-	-	-	-	531,370
Placements by HKSAR government funds and statutory bodies	74	-	-	-	-	-	74
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	1,024,697	58,531	42,861	75,708	14,974	4,036	1,220,807
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- On net basis	9	(6)	64	107	-	-	174
- On gross basis							
Total outflows	20,665	33,808	3,050	9,464	1,053	-	68,040
Total inflows	(19,038)	(31,461)	(2,959)	(9,426)	(1,046)	-	(63,930)
Total	1,636	2,341	155	145	7	-	4,284

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

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

	Fund – 2009						Total
	Remaining maturity						
	Up to 1 month or on demand	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
Certificates of Indebtedness	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	8,427	-	-	-	-	-	8,427
Balance of the banking system	264,567	-	-	-	-	-	264,567
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	6,836	-	-	-	35,000	-	41,836
Exchange Fund Bills and Notes issued	89,311	268,625	123,823	46,712	8,825	3,344	540,640
Other liabilities	11,530	243	223	-	-	-	11,996
Loan commitments and other credit related commitments	118,719	-	-	-	-	-	118,719
Total	1,230,830	268,868	124,046	46,712	43,825	3,344	1,717,625
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- On net basis	167	(16)	18	34	169	54	426
- On gross basis							
Total outflows	22,764	5,777	4,583	-	-	-	33,124
Total inflows	(22,356)	(5,728)	(4,554)	-	-	-	(32,638)
Total	575	33	47	34	169	54	912

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

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

	Fund – 2008 Remaining maturity						Total
	Up to 1 month or on demand	3 months or less but over 1 month	1 year or less but over 3 months	5 years or less but over 1 year	10 years or less but over 5 years	Over 10 years	
Non-derivative cash outflows							
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 Fiscal Reserves	531,370	-	-	-	-	-	531,370
Placements by HKSAR government funds and statutory bodies	74	-	-	-	-	-	74
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	1,034,853	56,407	38,015	47,732	9,397	2,083	1,188,487
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- On net basis	17	-	-	-	-	-	17
- On gross basis							
Total outflows	19,843	29,661	755	-	-	-	50,259
Total inflows	(18,252)	(27,319)	(719)	-	-	-	(46,290)
Total	1,608	2,342	36	-	-	-	3,986

36.6 Mortgage insurance risk

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

Under the Mortgage Insurance Programme, the Group, through the HKMC, offers mortgage insurance that covers approved sellers for credit losses of up to 25% - 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 2009, the total risk-in-force was HK\$14.92 billion (2008: HK\$9.83 billion), of which HK\$11.59 billion (2008: HK\$5.71 billion) was retained by the Group after reinsurance.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal risk that the Group faces under its insurance contracts is that the actual claims exceed the carrying amount of the insurance liabilities. This could occur because the frequency or severity of claims 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.

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

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

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

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

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

36.7 Operational risk

Operational risk is the risk of direct and indirect loss arising from a wide variety of causes associated with the Group's processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements. Operational risks arise from all of the Group's operations and are faced by all business segments.

The Group's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Group's reputation with overall cost-effectiveness and to avoid control procedures that restrict initiative.

The primary responsibility for the development and implementation of controls to address operational risk rests with an internal high-level Risk Committee. 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 forms an important 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 the 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.

37 FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. In the absence of such quoted market prices, fair values are estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date. The fair values of unlisted investment funds and unlisted equity securities are estimated by investment managers. These fair values approximate the net asset values of the investments. Depending on the redemption and liquidity features of the investments, the fair values may not necessarily represent the amounts that can be ultimately realised by the Group.

- (a) The fair values of held-to-maturity securities, other debt securities and mortgage-backed securities issued that were not designated at fair value, are shown below:

	Notes	Group			
		Carrying value		Fair value	
		2009	2008	2009	2008
Financial assets					
Held-to-maturity securities	11	5,883	5,713	6,001	5,743
Financial liabilities					
Other debt securities issued, not designated at fair value	26	41,613	38,073	41,619	38,079
Mortgage-backed securities issued, not designated at fair value	27	2,021	3,226	2,011	3,211

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 2009 and 2008.

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

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

- (b) The following table shows the carrying value of financial instruments measured at fair value at the balance sheet date across the three levels of the fair value hierarchy:

	Group - 2009			Total
	Level 1	Level 2	Level 3	
At 31 December 2009				
Assets				
Derivative financial instruments	12	5,553	-	5,565
Financial assets designated at fair value	1,729,460	238,740	27,264	1,995,464
Available-for-sale securities	1,104	2,509	3,572	7,185
	1,730,576	246,802	30,836	2,008,214
Liabilities				
Derivative financial instruments	167	864	-	1,031
Exchange Fund Bills and Notes issued	-	536,429	-	536,429
Other debt securities issued, designated at fair value	-	2,846	-	2,846
	167	540,139	-	540,306

	Fund - 2009			Total
	Level 1	Level 2	Level 3	
At 31 December 2009				
Assets				
Derivative financial instruments	12	4,235	-	4,247
Financial assets designated at fair value	1,729,460	238,740	27,264	1,995,464
	1,729,472	242,975	27,264	1,999,711
Liabilities				
Derivative financial instruments	167	706	-	873
Exchange Fund Bills and Notes issued	-	536,429	-	536,429
	167	537,135	-	537,302

The three levels of the fair value hierarchy are:

Level 1 – fair values of financial instruments are quoted prices in active markets for identical assets or liabilities;

Level 2 – fair values of financial instruments are determined involving inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices); and

Level 3 – fair values of financial instruments are determined with inputs that are not based on observable market data (unobservable inputs).

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

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

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

	Group		Fund	
	Designated at fair value	Available-for-sale	Designated at fair value	Available-for-sale
At 1 January 2009	18,704	–	18,704	–
Net gains recognised in the income and expenditure account	3,583	–	3,583	–
Net gains recognised in other comprehensive income	–	743	–	–
Purchases	13,337	2,848	13,337	–
Sales	(7,460)	(19)	(7,460)	–
Transfers out of Level 3	(900)	–	(900)	–
At 31 December 2009	27,264	3,572	27,264	–
Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date	3,123	–	3,123	–

During the year, the Group determined that significant unobservable inputs used in fair value measurements for certain financial assets designated at fair value were no longer needed and they were transferred out of Level 3 of the fair value hierarchy.

For financial instruments classified under Level 3 of the fair value hierarchy, if the prices of investments were increased/decreased by 10%, these would have resulted in an increase/decrease in the Group's surplus for the year of HK\$2,726 million and in other comprehensive income of HK\$357 million.

38 COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the current year's presentation (note 3.2).

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

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

39 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2009

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 2009 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 27 (Revised), Consolidated and Separate Financial Statements	1 July 2009
Amendment to HKAS 39, Financial Instruments: Recognition and Measurement – Eligible Hedged Items	1 July 2009
Amendment to HKAS 32, Financial Instruments: Presentation – Classification of Rights Issues	1 February 2010
HKAS 24 (Revised), Related Party Disclosures	1 January 2011
HKFRS 9, Financial Instruments	1 January 2013

40 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 1 April 2010.