

# 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 120 to 201, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2010, 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 information.

#### Monetary Authority's Responsibility for the Financial Statements

The Monetary Authority is responsible for the preparation of financial statements that give a true and fair view 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, and for such internal control as the Monetary Authority determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

#### 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 about 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 of financial statements that give a true and fair view 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 (continued)

## 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 2010, 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

29 March 2011

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

# Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
<b>INCOME</b>					
Interest income		<b>20,524</b>	22,628	<b>19,231</b>	21,303
Dividend income		<b>8,433</b>	7,181	<b>8,614</b>	7,379
Net realised and revaluation gains		<b>55,871</b>	72,810	<b>55,547</b>	72,777
Net exchange gains/(losses)		<b>(3,026)</b>	9,762	<b>(3,074)</b>	9,772
Investment income	4(a)	<b>81,802</b>	112,381	<b>80,318</b>	111,231
Bank licence fees		<b>134</b>	134	<b>134</b>	134
Other income		<b>626</b>	388	<b>74</b>	127
<b>TOTAL INCOME</b>		<b>82,562</b>	112,903	<b>80,526</b>	111,492
<b>EXPENDITURE</b>					
Interest expense	4(b)	<b>(39,833)</b>	(36,063)	<b>(39,663)</b>	(35,784)
Operating expenses	4(c)	<b>(2,781)</b>	(2,622)	<b>(2,529)</b>	(2,403)
Note and coin expenses	4(d)	<b>(288)</b>	(333)	<b>(288)</b>	(333)
Write back of impairment losses on loans		<b>17</b>	37	<b>-</b>	-
<b>TOTAL EXPENDITURE</b>		<b>(42,885)</b>	(38,981)	<b>(42,480)</b>	(38,520)
<b>SURPLUS BEFORE SHARE OF PROFIT/(LOSS) OF ASSOCIATE AND JOINT VENTURES</b>					
		<b>39,677</b>	73,922	<b>38,046</b>	72,972
Share of profit/(loss) of associate and joint ventures, net of tax		<b>(154)</b>	2	<b>-</b>	-
<b>SURPLUS BEFORE TAXATION</b>		<b>39,523</b>	73,924	<b>38,046</b>	72,972
Income tax		<b>(178)</b>	(150)	<b>-</b>	-
<b>SURPLUS FOR THE YEAR</b>		<b>39,345</b>	73,774	<b>38,046</b>	72,972
<b>ATTRIBUTABLE TO:</b>					
Owner of the Fund		<b>39,333</b>	73,759	<b>38,046</b>	72,972
Non-controlling interests		<b>12</b>	15	<b>-</b>	-
		<b>39,345</b>	73,774	<b>38,046</b>	72,972

The notes on pages 126 to 201 form part of these financial statements.

# Exchange Fund – Statement of Comprehensive Income

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
<b>SURPLUS FOR THE YEAR</b>		<b>39,345</b>	73,774	<b>38,046</b>	72,972
<b>OTHER COMPREHENSIVE INCOME</b>					
Available-for-sale securities					
fair value changes taken to equity	27	<b>1,248</b>	973	-	-
fair value changes on disposal transferred to income and expenditure account	27	<b>(40)</b>	(4)	-	-
tax effect	27	<b>(17)</b>	(37)	-	-
Cash flow hedges					
fair value changes taken to equity	27	<b>26</b>	25	-	-
tax effect	27	<b>(4)</b>	(4)	-	-
Exchange difference on translation of financial statements of overseas subsidiaries and joint ventures	27	<b>48</b>	2	-	-
<b>OTHER COMPREHENSIVE INCOME FOR THE YEAR, NET OF TAX</b>		<b>1,261</b>	955	-	-
<b>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</b>		<b>40,606</b>	74,729	<b>38,046</b>	72,972
<b>TOTAL COMPREHENSIVE INCOME FOR THE YEAR ATTRIBUTABLE TO:</b>					
Owner of the Fund		<b>40,594</b>	74,714	<b>38,046</b>	72,972
Non-controlling interests		<b>12</b>	15	-	-
		<b>40,606</b>	74,729	<b>38,046</b>	72,972

The notes on pages 126 to 201 form part of these financial statements.

# Exchange Fund – Balance Sheet

as at 31 December 2010

	Note	Group		Fund	
		2010	2009	2010	2009
(Expressed in millions of Hong Kong dollars)					
<b>ASSETS</b>					
Cash and money at call	6	49,579	17,736	48,911	17,658
Placements with banks and other financial institutions	7	155,455	112,732	149,478	108,636
Derivative financial instruments	8(a)	3,299	5,565	1,902	4,247
Financial assets designated at fair value	9	2,108,964	1,995,464	2,104,562	1,995,464
Available-for-sale securities	10	12,326	7,678	493	493
Held-to-maturity securities	11	8,108	5,883	–	–
Loan portfolio	12	35,259	43,789	–	–
Gold	13	732	572	732	572
Other assets	14	19,772	15,063	18,770	14,007
Investments in subsidiaries	15	–	–	16,828	4,947
Interests in associate and joint ventures	16	3,461	160	–	–
Property, plant and equipment	17(a)	3,501	3,603	3,308	3,374
<b>TOTAL ASSETS</b>		<b>2,400,456</b>	2,208,245	<b>2,344,984</b>	2,149,398
<b>LIABILITIES AND EQUITY</b>					
Certificates of Indebtedness	18	225,939	199,006	225,939	199,006
Government-issued currency notes and coins in circulation	18	8,899	8,427	8,899	8,427
Balance of the banking system	19	148,702	264,567	148,702	264,567
Derivative financial instruments	8(a)	2,473	1,031	2,429	873
Placements by banks and other financial institutions	20	23,187	28,311	23,187	28,311
Placements by Fiscal Reserves	21	592,282	504,123	592,282	504,123
Placements by Hong Kong Special Administrative Region government funds and statutory bodies	22	76,760	41,836	76,760	41,836
Exchange Fund Bills and Notes issued	23	653,721	536,429	654,221	536,429
Other debt securities issued	24	39,100	44,459	–	–
Mortgage-backed securities issued	25	1,530	2,021	–	–
Other liabilities	26	27,919	18,753	21,062	12,369
<b>Total liabilities</b>		<b>1,800,512</b>	1,648,963	<b>1,753,481</b>	1,595,941
Accumulated surplus	27	597,553	558,220	591,503	553,457
Other reserves	27	2,119	858	–	–
Total equity attributable to owner of the Fund		599,672	559,078	591,503	553,457
Non-controlling interests	27	272	204	–	–
<b>Total equity</b>		<b>599,944</b>	559,282	<b>591,503</b>	553,457
<b>TOTAL LIABILITIES AND EQUITY</b>		<b>2,400,456</b>	2,208,245	<b>2,344,984</b>	2,149,398

**Norman T.L. Chan**

Monetary Authority

29 March 2011

The notes on pages 126 to 201 form part of these financial statements.

# Exchange Fund – Statement of Changes in Equity

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
<b>Attributable to owner of the Fund</b>					
<b>Accumulated surplus</b>					
At 1 January		<b>558,220</b>	484,461	<b>553,457</b>	480,485
Surplus for the year	27	<b>39,333</b>	73,759	<b>38,046</b>	72,972
At 31 December		<b>597,553</b>	558,220	<b>591,503</b>	553,457
<b>Other reserves</b>					
Revaluation reserve					
At 1 January		<b>865</b>	(88)	-	-
Other comprehensive income for the year	27	<b>1,213</b>	953	-	-
At 31 December		<b>2,078</b>	865	-	-
Translation reserve					
At 1 January		<b>(7)</b>	(9)	-	-
Other comprehensive income for the year	27	<b>48</b>	2	-	-
At 31 December		<b>41</b>	(7)	-	-
		<b>2,119</b>	858	-	-
<b>Total equity attributable to owner of the Fund at 31 December</b>		<b>599,672</b>	559,078	<b>591,503</b>	553,457
<b>Non-controlling interests</b>					
At 1 January		<b>204</b>	191	-	-
Total comprehensive income for the year	27	<b>12</b>	15	-	-
Capital injection by non-controlling interests	27	<b>67</b>	11	-	-
Dividends paid to non-controlling interests	27	<b>(11)</b>	(13)	-	-
At 31 December		<b>272</b>	204	-	-
<b>Total equity at 31 December</b>		<b>599,944</b>	559,282	<b>591,503</b>	553,457

The notes on pages 126 to 201 form part of these financial statements.

# Exchange Fund – Statement of Cash Flows

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
<b>Cash flows from operating activities</b>					
Surplus before share of profit/(loss) of associate and joint ventures		<b>39,677</b>	73,922	<b>38,046</b>	72,972
<b>Adjustments for:</b>					
Interest income	4(a)	<b>(20,524)</b>	(22,628)	<b>(19,231)</b>	(21,303)
Dividend income	4(a)	<b>(8,433)</b>	(7,181)	<b>(8,614)</b>	(7,379)
Net gains on available-for-sale securities	4(a)	<b>(167)</b>	(20)	<b>-</b>	-
Interest expense	4(b)	<b>39,833</b>	36,063	<b>39,663</b>	35,784
Depreciation	4(c)	<b>148</b>	140	<b>110</b>	106
Elimination of exchange differences and other non-cash items		<b>(556)</b>	(976)	<b>(556)</b>	(938)
Interest received		<b>20,636</b>	23,934	<b>19,396</b>	22,590
Interest paid		<b>(39,798)</b>	(36,063)	<b>(39,729)</b>	(35,811)
Dividends received		<b>8,427</b>	7,214	<b>8,095</b>	7,150
Income tax paid		<b>(174)</b>	(64)	<b>-</b>	-
		<b>39,069</b>	74,341	<b>37,180</b>	73,171
Change in fair value of derivatives and other debt securities issued		<b>3,959</b>	451	<b>3,927</b>	390
Change in placements with banks and other financial institutions		<b>(361)</b>	(879)	<b>753</b>	(931)
Change in financial assets designated at fair value		<b>(183,361)</b>	(592,838)	<b>(178,959)</b>	(592,838)
Change in loan portfolio		<b>8,542</b>	7,008	<b>-</b>	-
Change in gold		<b>(160)</b>	(124)	<b>(160)</b>	(124)
Change in other assets		<b>(4,814)</b>	3,181	<b>(4,928)</b>	2,492
Change in Certificates of Indebtedness, government-issued currency notes and coins in circulation		<b>27,405</b>	23,074	<b>27,405</b>	23,074
Change in balance of the banking system		<b>(115,865)</b>	106,529	<b>(115,865)</b>	106,529
Change in placements by banks and other financial institutions		<b>(5,124)</b>	14,698	<b>(5,124)</b>	14,698
Change in placements by Fiscal Reserves		<b>88,159</b>	(27,247)	<b>88,159</b>	(27,247)
Change in placements by Hong Kong Special Administrative Region government funds and statutory bodies		<b>34,924</b>	41,762	<b>34,924</b>	41,762
Change in Exchange Fund Bills and Notes issued		<b>117,292</b>	373,875	<b>117,792</b>	373,875
Change in other liabilities		<b>9,144</b>	(12,874)	<b>8,739</b>	(13,509)
<b>Net cash from operating activities</b>		<b>18,809</b>	10,957	<b>13,843</b>	1,342



# Exchange Fund – Statement of Cash Flows (continued)

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2010	2009	2010	2009
<b>Cash flows from investing activities</b>					
Loans to subsidiaries		-	-	(11,881)	(2,802)
Loan repayments received from a subsidiary		-	-	-	8,000
(Increase)/Decrease in investment in joint ventures		(3,443)	2	-	-
Proceeds from sale or redemption of available-for-sale securities		4,944	1,845	-	-
Purchase of available-for-sale securities		(8,215)	(5,982)	-	-
Proceeds from redemption of held-to-maturity securities		2,152	2,817	-	-
Purchase of held-to-maturity securities		(4,375)	(2,978)	-	-
Proceeds from disposal of property, plant and equipment		3	-	-	-
Purchase of property, plant and equipment		(57)	(95)	(44)	(32)
Dividends received from subsidiaries		-	-	513	266
<b>Net cash from/(used in) investing activities</b>		<b>(8,991)</b>	<b>(4,391)</b>	<b>(11,412)</b>	<b>5,432</b>
<b>Cash flows from financing activities</b>					
Proceeds from issue of other debt securities		8,193	22,061	-	-
Redemption of other debt securities issued		(13,831)	(19,652)	-	-
Redemption of mortgage-backed securities issued		(470)	(1,172)	-	-
Capital injection by non-controlling interests		67	11	-	-
Dividends paid to non-controlling interests		(11)	(13)	-	-
<b>Net cash from/(used in) financing activities</b>		<b>(6,052)</b>	<b>1,235</b>	<b>-</b>	<b>-</b>
<b>Net increase in cash and cash equivalents</b>		<b>3,766</b>	<b>7,801</b>	<b>2,431</b>	<b>6,774</b>
<b>Cash and cash equivalents at 1 January</b>		<b>208,120</b>	<b>199,380</b>	<b>204,249</b>	<b>196,537</b>
<b>Effect of foreign exchange rate changes</b>		<b>578</b>	<b>939</b>	<b>556</b>	<b>938</b>
<b>Cash and cash equivalents at 31 December</b>	28	<b>212,464</b>	<b>208,120</b>	<b>207,236</b>	<b>204,249</b>

The notes on pages 126 to 201 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 (Cap. 66). 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 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 29.

## 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 Fund and its subsidiaries (together referred to as 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 (continued)

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

## 2.2 Basis of preparation of the financial statements

The Group's financial statements include the financial statements of the Group as well as the Group's interests in an associate and joint ventures. The principal activities of the principal subsidiaries, the associate and the joint ventures are shown in notes 15 and 16.

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 35 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 (continued)

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

Non-controlling interests represent the equity in a subsidiary not attributable directly or indirectly to the Fund, 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. Non-controlling interests are presented in the Group balance sheet within equity, separately from equity attributable to the owner of the Fund. Non-controlling 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 non-controlling interests and the owner of the Fund.

In the balance sheet of the Fund, its investments in subsidiaries are stated at cost less impairment losses, if any (note 2.12).

## **2.4 Associate and joint ventures**

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.

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, adjusted for any excess of the Group's share of the acquisition-date fair values of the investee's identifiable net assets over the cost of the investment (if any). Thereafter, the investment is adjusted 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 ventures for the year. Unrealised profits and losses resulting from transactions between the Group and its associate and joint ventures are eliminated to the extent of the Group's interests in the associate or the joint ventures.

In the balance sheet of the Fund, its investments in associate and joint ventures are stated at cost less impairment losses, if any (note 2.12).

# Exchange Fund – Notes to the Financial Statements *(continued)*

(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 values, which normally 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 assets or the issue of the financial liabilities. 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 (continued)

(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 (continued)

(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. 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 are stated at the principal amount payable.

Other financial liabilities with a fixed maturity and a predetermined rate are carried 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.

### 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 closing exchange rate at the balance sheet date.

# Exchange Fund – Notes to the Financial Statements (continued)

(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, is 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 *(continued)*

(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 offset the recognised amounts and there is an intention to settle on a net basis, or realise the assets and settle the liabilities 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.

An embedded derivative is 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 *(continued)*

(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 documents, at the inception of the transaction, the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Group also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

### **2.8.1 Fair value hedge**

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

Derivatives that are designated and qualified 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) a hedging instrument expires or is sold, terminated or exercised; (b) a hedge no longer meets the criteria for hedge accounting; or (c) the Group revokes designation of the hedge relationship, any adjustment to the carrying amount of a hedged item for which the effective interest method is used, is amortised to the income and expenditure account over the period to maturity.

### **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 portion of any gain or loss from 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) a hedging instrument expires or is sold, terminated or exercised; (b) a hedge no longer meets the criteria for hedge accounting; or (c) the Group revokes designation of the hedge relationship, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when 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 recognised in equity is immediately transferred to the income and expenditure account.

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 2.9 Impairment of financial assets

The carrying amounts 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 2.12):

- a building held for own use situated on freehold land;
- land classified as held under a finance lease and building held for own use situated thereon;
- plant and equipment, including plant, machinery, furniture, fixtures, equipment, motor vehicles and personal computers; and
- computer software licences and system development costs.

# Exchange Fund – Notes to the Financial Statements (continued)

(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
- leasehold land classified as held under a finance lease depreciated over the unexpired term of lease
- 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 to 15 years
- computer software licences and system development costs 3 to 5 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 Impairment of other assets

The carrying amounts of other assets, including investments in subsidiaries, investments in associate and joint ventures, and property, plant and equipment, 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.

## 2.13 Cash and cash equivalents

Cash and cash equivalents comprise cash and 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.

# Exchange Fund – Notes to the Financial Statements (continued)

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

## **2.14 Revenue and expenditure recognition**

### **2.14.1 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 21 and 22). 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 instrument but does not consider future credit losses. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

### **2.14.2 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.

### **2.14.3 Dividend and other income**

Dividend income from listed equity securities is recognised in the income and expenditure account 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 (Cap. 155) and are accounted for in the period when the fees become receivable.

Other income includes rental income, income from the sale of withdrawn coins, Central Moneymarkets Unit fee income and net insurance premiums earned from mortgage insurance business of the HKMC. Rental income is recognised on a straight-line basis over the lease term. Other income is accounted for in the period when it becomes receivable.

## Exchange Fund – Notes to the Financial Statements (continued)

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

### 2.14.4 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.

### 2.14.5 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.

### 2.14.6 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 assets can be utilised. Deferred tax liabilities are provided in full.

## 2.15 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 using the spot exchange rates at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars using the closing exchange rate 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 spot exchange rates 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 closing exchange rates at the dates when the fair value is determined.

All foreign currency translation 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.

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 2.16 Related parties

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

- (a) the party has the ability, directly or indirectly, to control the Group or exercise significant influence over the Group in making financial and operating policy decisions, or has joint control over the Group;
- (b) the Group and the party are subject to common control;
- (c) the party is an associate of the Group or a joint venture in which the Group is a venturer;
- (d) the party is a member of key management personnel of the Group, or a close family member of such an individual, or is an entity under the control, joint control or significant influence of such individuals;
- (e) the party is a close family member of a party referred to in (a) or is an entity under the control, joint control or significant influence of such individuals; or
- (f) the party is a post-employment benefit plan which is for the benefit of employees of the Group or of any entity that is a related party of the Group.

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

## 2.17 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 29.

# Exchange Fund – Notes to the Financial Statements *(continued)*

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

## **3 CHANGES IN ACCOUNTING POLICIES**

The HKICPA has issued certain new and revised HKFRSs that are effective for the current accounting period. There have been no 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 Amendment to HKAS 17, Leases, there are changes to the classification of a leasehold land interest in the financial statements.

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

### **3.1 HKAS 27 (Revised), Consolidated and Separate Financial Statements**

The revised standard requires the effects of all equity transactions with non-controlling interests to be recorded in equity if control is retained and these transactions will not result in goodwill or gains or losses. The standard also specifies the accounting when control is lost. Any remaining interest in the entity is re-measured at fair value, and a gain or loss is recognised in income and expenditure account. HKAS 27 (Revised) does not have any impact on the financial statements as there were no equity transactions related to non-controlling interests.

### **3.2 Amendment to HKAS 39, Financial Instruments: Recognition and Measurement – Cash Flow Hedge Accounting**

The amendment, which is part of the improvement to HKFRSs (2009), clarifies that gains or losses should be reclassified from equity to income and expenditure account in the period in which the hedged forecast cash flow affects investment income. There is no material impact to the financial statements of the Group as a result of this amendment.



# Exchange Fund – Notes to the Financial Statements (continued)

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

## 3.3 Amendment to HKAS 17, Leases – Classification of Leases of Land and Buildings

The amendment, which is part of the improvement to HKFRSs (2009), removes the requirement that interests in leasehold land should be classified as an operating lease unless the lessee acquires legal title at the end of the lease. The amendment requires the classification of leasehold land to be based on the general principles set out in HKAS 17, that are based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

As a result of this amendment, the Group has re-evaluated the classification of its interest in leasehold land as to whether in the Group's judgement, the lease transfer significantly all the risks and rewards of ownership of the land such that the Group is in a position economically similar to that of a purchaser. The Group has concluded that its interest in leasehold land, which is registered and located in the Hong Kong Special Administrative Region, should no longer be classified as operating leases. Instead, such interests of leasehold land should be reclassified as finance leases. As a result, split of the land and buildings elements is no longer necessary as both of them are under finance lease. Operating land lease prepayment of the Group and the Fund has been reclassified to property, plant and equipment (note 17) and amortisation of the land element has been reclassified to depreciation retrospectively.

The adjustments that have been made in accordance with the amendment to each of the line items in the balance sheet as previously reported as at 1 January 2009 and 31 December 2009 are set out below. Such reclassification had no impact on the income and expenditure account.

The presentation of "Property, plant and equipment" (note 17(a)) has been changed to include computer software licences and system development costs which were shown as "Intangible assets" in the 2009 balance sheet.

### 3.3.1 Effect on the balance sheet as at 1 January 2009

	Group			Fund		
	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)
<b>ASSETS</b>						
Property, plant and equipment	786	2,849	3,635	584	2,849	3,433
Operating land lease prepayment	2,849	(2,849)	-	2,849	(2,849)	-
	3,635	-	3,635	3,433	-	3,433
Intangible assets	15	-	15	15	-	15
	3,650	-	3,650	3,448	-	3,448

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 3.3.2 Effect on the balance sheet as at 31 December 2009 and 1 January 2010

	Group			Fund		
	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)	2009 (as previously reported)	Effect on adoption of HKAS 17	2009 (restated)
<b>ASSETS</b>						
Property, plant and equipment	812	2,775	3,587	583	2,775	3,358
Operating land lease prepayment	2,775	(2,775)	-	2,775	(2,775)	-
	3,587	-	3,587	3,358	-	3,358
Intangible assets	16	-	16	16	-	16
	3,603	-	3,603	3,374	-	3,374

## 4 INCOME AND EXPENDITURE

### (a) Investment income

	Group		Fund	
	2010	2009	2010	2009
Interest income:				
– from derivative financial instruments	<b>395</b>	293	<b>395</b>	293
– from financial assets designated at fair value	<b>18,581</b>	20,637	<b>18,454</b>	20,637
– from other financial assets	<b>1,548</b>	1,698	<b>382</b>	373
	<b>20,524</b>	22,628	<b>19,231</b>	21,303
Dividend income:				
– from financial assets designated at fair value	<b>8,067</b>	7,102	<b>8,067</b>	7,102
– from other financial assets	<b>366</b>	79	<b>35</b>	14
– from subsidiaries	<b>-</b>	-	<b>512</b>	263
	<b>8,433</b>	7,181	<b>8,614</b>	7,379
Net realised and revaluation gains:				
– on derivative financial instruments	<b>777</b>	5,390	<b>578</b>	6,204
– on financial assets and financial liabilities designated at fair value	<b>54,927</b>	67,400	<b>54,969</b>	66,573
– on disposal of available-for-sale securities	<b>167</b>	20	<b>-</b>	-
	<b>55,871</b>	72,810	<b>55,547</b>	72,777
Net exchange gains/(losses)	<b>(3,026)</b>	9,762	<b>(3,074)</b>	9,772
<b>TOTAL</b>	<b>81,802</b>	112,381	<b>80,318</b>	111,231

## Exchange Fund – Notes to the Financial Statements (continued)

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

### (b) Interest expense

	Group		Fund	
	2010	2009	2010	2009
Interest expense on derivative financial instruments	<b>194</b>	94	<b>194</b>	94
Interest expense on Exchange Fund Bills and Notes and other debt securities issued designated at fair value and trading liabilities	<b>1,984</b>	1,166	<b>1,817</b>	940
Interest expense on other financial liabilities	<b>37,655</b>	34,803	<b>37,652</b>	34,750
<b>TOTAL</b>	<b>39,833</b>	36,063	<b>39,663</b>	35,784
Comprises:				
Interest on placements by Fiscal Reserves:				
– at a fixed rate determined annually	<b>33,765</b>	33,486	<b>33,765</b>	33,486
– at market-based rates	<b>1</b>	1	<b>1</b>	1
Interest on placements by HKSAR government funds and statutory bodies:				
– at a fixed rate determined annually	<b>3,863</b>	1,245	<b>3,863</b>	1,245
Interest on Exchange Fund Bills and Notes issued	<b>1,814</b>	940	<b>1,815</b>	940
Other interest expense	<b>390</b>	391	<b>219</b>	112
	<b>39,833</b>	36,063	<b>39,663</b>	35,784

## Exchange Fund – Notes to the Financial Statements (continued)

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

### (c) Operating expenses

	Group		Fund	
	2010	2009	2010	2009
Staff costs				
Salaries and other staff costs	<b>843</b>	785	<b>697</b>	645
Retirement benefit costs	<b>61</b>	57	<b>53</b>	50
Premises and equipment expenses				
Depreciation	<b>148</b>	140	<b>110</b>	106
Rental expenses under operating leases	<b>44</b>	37	<b>42</b>	36
Other premises expenses	<b>53</b>	51	<b>44</b>	42
General operating costs				
Maintenance of office and computer equipment	<b>45</b>	46	<b>38</b>	39
Financial information and communication services	<b>41</b>	39	<b>36</b>	34
External relations	<b>25</b>	19	<b>23</b>	17
Service fees for financial infrastructure	<b>27</b>	40	<b>27</b>	40
Other professional services	<b>54</b>	58	<b>35</b>	45
Training	<b>6</b>	6	<b>6</b>	5
Others	<b>23</b>	18	<b>22</b>	21
Investment management and custodian fees				
Management and custodian fees	<b>789</b>	688	<b>777</b>	688
Transaction costs	<b>178</b>	239	<b>175</b>	236
Withholding tax	<b>427</b>	382	<b>427</b>	382
Others	<b>17</b>	17	<b>17</b>	17
<b>TOTAL</b>	<b>2,781</b>	2,622	<b>2,529</b>	2,403

## Exchange Fund – Notes to the Financial Statements (continued)

(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	
	2010	2009
Fixed pay	57.2	58.3
Variable pay	10.3	14.5
Other benefits	5.7	6.8
	<b>73.2</b>	79.6

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

HK\$	Group	
	2010	2009
500,000 or below	1	–
1,000,001 to 1,500,000	–	1
1,500,001 to 2,000,000	1	1
2,000,001 to 2,500,000	3	–
3,000,001 to 3,500,000	2	2
3,500,001 to 4,000,000	1	3
4,000,001 to 4,500,000	4	5
4,500,001 to 5,000,000	1	–
5,000,001 to 5,500,000	1	1
5,500,001 to 6,000,000	1	–
6,500,001 to 7,000,000	2	1
7,000,001 to 7,500,000	–	1
7,500,001 to 8,000,000	1	1
10,000,001 to 10,500,000	–	1
	<b>18</b>	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 (continued)

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

## 5 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

	Note	Total	Group – 2010					Other financial liabilities
			Trading financial instruments and hedging instruments	Financial assets and liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	
Cash and money at call	6	49,579	-	-	49,579	-	-	-
Placements with banks and other financial institutions	7	155,455	-	-	155,455	-	-	-
Derivative financial instruments	8(a)	3,299	3,299	-	-	-	-	-
Financial assets designated at fair value	9	2,108,964	-	2,108,964	-	-	-	-
Available-for-sale securities	10	12,326	-	-	-	-	12,326	-
Held-to-maturity securities	11	8,108	-	-	-	8,108	-	-
Loan portfolio	12	35,259	-	-	35,259	-	-	-
Other assets	14	19,772	-	-	19,772	-	-	-
<b>FINANCIAL ASSETS</b>		<b>2,392,762</b>	<b>3,299</b>	<b>2,108,964</b>	<b>260,065</b>	<b>8,108</b>	<b>12,326</b>	<b>-</b>
Certificates of Indebtedness	18	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	18	8,899	-	-	-	-	-	8,899
Balance of the banking system	19	148,702	-	-	-	-	-	148,702
Derivative financial instruments	8(a)	2,473	2,473	-	-	-	-	-
Placements by banks and other financial institutions	20	23,187	-	-	-	-	-	23,187
Placements by Fiscal Reserves	21	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	22	76,760	-	-	-	-	-	76,760
Exchange Fund Bills and Notes issued	23	653,721	-	653,721	-	-	-	-
Other debt securities issued	24	39,100	-	1,937	-	-	-	37,163
Mortgage-backed securities issued	25	1,530	-	-	-	-	-	1,530
Other liabilities	26	27,919	-	-	-	-	-	27,919
<b>FINANCIAL LIABILITIES</b>		<b>1,800,512</b>	<b>2,473</b>	<b>655,658</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,142,381</b>

# Exchange Fund – Notes to the Financial Statements (continued)

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

	Note	Total	Group – 2009					
			Trading financial instruments and hedging 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	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	-	-	-
<b>FINANCIAL ASSETS</b>		<b>2,203,910</b>	<b>5,565</b>	<b>1,995,464</b>	<b>189,320</b>	<b>5,883</b>	<b>7,678</b>	<b>-</b>
Certificates of Indebtedness	18	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	18	8,427	-	-	-	-	-	8,427
Balance of the banking system	19	264,567	-	-	-	-	-	264,567
Derivative financial instruments	8(a)	1,031	1,031	-	-	-	-	-
Placements by banks and other financial institutions	20	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	21	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	22	41,836	-	-	-	-	-	41,836
Exchange Fund Bills and Notes issued	23	536,429	-	536,429	-	-	-	-
Other debt securities issued	24	44,459	-	2,846	-	-	-	41,613
Mortgage-backed securities issued	25	2,021	-	-	-	-	-	2,021
Other liabilities	26	18,753	-	-	-	-	-	18,753
<b>FINANCIAL LIABILITIES</b>		<b>1,648,963</b>	<b>1,031</b>	<b>539,275</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,108,657</b>

## Exchange Fund – Notes to the Financial Statements (continued)

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

	Note	Total	Fund – 2010					
			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	48,911	-	-	48,911	-	-	-
Placements with banks and other financial institutions	7	149,478	-	-	149,478	-	-	-
Derivative financial instruments	8(a)	1,902	1,902	-	-	-	-	-
Financial assets designated at fair value	9	2,104,562	-	2,104,562	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Other assets	14	18,770	-	-	18,770	-	-	-
<b>FINANCIAL ASSETS</b>		<b>2,324,116</b>	<b>1,902</b>	<b>2,104,562</b>	<b>217,159</b>	<b>-</b>	<b>493</b>	<b>-</b>
Certificates of Indebtedness	18	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	18	8,899	-	-	-	-	-	8,899
Balance of the banking system	19	148,702	-	-	-	-	-	148,702
Derivative financial instruments	8(a)	2,429	2,429	-	-	-	-	-
Placements by banks and other financial institutions	20	23,187	-	-	-	-	-	23,187
Placements by Fiscal Reserves	21	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	22	76,760	-	-	-	-	-	76,760
Exchange Fund Bills and Notes issued	23	654,221	-	654,221	-	-	-	-
Other liabilities	26	21,062	-	-	-	-	-	21,062
<b>FINANCIAL LIABILITIES</b>		<b>1,753,481</b>	<b>2,429</b>	<b>654,221</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,096,831</b>



## Exchange Fund – Notes to the Financial Statements (continued)

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

		Fund – 2009						
	Note	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	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	-	-	-
<b>FINANCIAL ASSETS</b>		<b>2,140,505</b>	<b>4,247</b>	<b>1,995,464</b>	<b>140,301</b>	<b>-</b>	<b>493</b>	<b>-</b>
Certificates of Indebtedness	18	199,006	-	-	-	-	-	199,006
Government-issued currency notes and coins in circulation	18	8,427	-	-	-	-	-	8,427
Balance of the banking system	19	264,567	-	-	-	-	-	264,567
Derivative financial instruments	8(a)	873	873	-	-	-	-	-
Placements by banks and other financial institutions	20	28,311	-	-	-	-	-	28,311
Placements by Fiscal Reserves	21	504,123	-	-	-	-	-	504,123
Placements by HKSAR government funds and statutory bodies	22	41,836	-	-	-	-	-	41,836
Exchange Fund Bills and Notes issued	23	536,429	-	536,429	-	-	-	-
Other liabilities	26	12,369	-	-	-	-	-	12,369
<b>FINANCIAL LIABILITIES</b>		<b>1,595,941</b>	<b>873</b>	<b>536,429</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,058,639</b>

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 6 CASH AND MONEY AT CALL

	Group		Fund	
	2010	2009	2010	2009
At amortised cost				
Balance with central banks	<b>24,212</b>	1,339	<b>24,212</b>	1,339
Balance with banks	<b>25,367</b>	16,397	<b>24,699</b>	16,319
<b>TOTAL</b>	<b>49,579</b>	17,736	<b>48,911</b>	17,658

## 7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2010	2009	2010	2009
At amortised cost				
Placements in respect of reverse repurchase agreements:				
– with central banks	<b>38,897</b>	38,795	<b>38,897</b>	38,795
– with banks and other financial institutions	<b>5,018</b>	1,916	<b>5,018</b>	1,916
Other placements with banks	<b>111,540</b>	72,021	<b>105,563</b>	67,925
<b>TOTAL</b>	<b>155,455</b>	112,732	<b>149,478</b>	108,636

## 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 34.

# Exchange Fund – Notes to the Financial Statements (continued)

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

## (a) Fair values of derivative financial instruments

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

	Group				Fund			
	2010		2009		2010		2009	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
<b>Derivatives categorised as trading financial instruments</b>								
Interest rate derivatives								
Interest rate swap contracts	647	226	812	308	582	199	685	201
Interest rate futures contracts	1	-	6	-	1	-	6	-
Equity index swaps	-	8	-	-	-	8	-	-
Currency derivatives								
Forward foreign exchange contracts	1,292	1,937	3,550	483	1,279	1,929	3,550	482
Others								
Stock index futures contracts	13	279	-	161	13	279	-	161
Bond futures contracts	27	14	6	6	27	14	6	6
Bond options contracts	-	-	-	23	-	-	-	23
	<b>1,980</b>	<b>2,464</b>	4,374	981	<b>1,902</b>	<b>2,429</b>	4,247	873
<b>Derivatives designated as hedging instruments in fair value hedges</b>								
Interest rate derivatives								
Interest rate swap contracts	1,029	3	1,035	3	-	-	-	-
Currency derivatives								
Currency swap contracts	290	2	134	40	-	-	-	-
	<b>1,319</b>	<b>5</b>	1,169	43	<b>-</b>	<b>-</b>	-	-
<b>Derivatives designated as hedging instruments in cash flow hedges</b>								
Currency derivatives								
Currency swap contracts	-	4	22	7	-	-	-	-
<b>TOTAL</b>	<b>3,299</b>	<b>2,473</b>	5,565	1,031	<b>1,902</b>	<b>2,429</b>	4,247	873

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 (continued)

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

## (b) Notional amounts of derivative financial instruments

An analysis of the notional amounts of derivative financial instruments held at the balance sheet date based on the remaining periods to settlement is set out below. The notional amounts of these instruments indicate the volume of outstanding transactions and do not represent the amounts at risk.

	Group									
	Notional amounts with remaining life of									
	Total	2010				Total	2009			
3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	
<b>Derivatives categorised as trading financial instruments</b>										
Interest rate derivatives										
Interest rate swap contracts	23,650	200	5,809	9,362	8,279	63,366	3,382	11,171	39,834	8,979
Interest rate futures contracts	2,909	638	1,919	352	-	12,724	601	11,525	598	-
Equity index swaps	520	-	520	-	-	-	-	-	-	-
Currency derivatives										
Forward foreign exchange contracts	187,985	159,440	23,187	5,358	-	161,442	156,198	5,244	-	-
Others										
Stock index futures contracts	32,664	32,664	-	-	-	17,029	17,029	-	-	-
Bond futures contracts	7,818	7,818	-	-	-	5,923	5,923	-	-	-
Bond options contracts	-	-	-	-	-	3,102	3,102	-	-	-
	<b>255,546</b>	<b>200,760</b>	<b>31,435</b>	<b>15,072</b>	<b>8,279</b>	<b>263,586</b>	<b>186,235</b>	<b>27,940</b>	<b>40,432</b>	<b>8,979</b>
<b>Derivatives designated as hedging instruments in fair value hedges</b>										
Interest rate derivatives										
Interest rate swap contracts	27,331	3,868	7,695	11,493	4,275	31,373	2,968	5,724	18,406	4,275
Currency derivatives										
Currency swap contracts	7,488	1,091	1,865	4,532	-	8,629	740	876	7,013	-
	<b>34,819</b>	<b>4,959</b>	<b>9,560</b>	<b>16,025</b>	<b>4,275</b>	<b>40,002</b>	<b>3,708</b>	<b>6,600</b>	<b>25,419</b>	<b>4,275</b>
<b>Derivatives designated as hedging instruments in cash flow hedges</b>										
Currency derivatives										
Currency swap contracts	2,354	-	-	2,354	-	11,761	861	-	10,900	-
<b>TOTAL</b>	<b>292,719</b>	<b>205,719</b>	<b>40,995</b>	<b>33,451</b>	<b>12,554</b>	<b>315,349</b>	<b>190,804</b>	<b>34,540</b>	<b>76,751</b>	<b>13,254</b>

# Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund									
	Notional amounts with remaining life of									
	Total	2010				Total	2009			
3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	3 months or less		1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	
<b>Derivatives categorised as trading financial instruments</b>										
Interest rate derivatives										
Interest rate swap contracts	16,206	-	1,000	7,241	7,965	42,629	-	-	33,853	8,776
Interest rate futures contracts	2,909	638	1,919	352	-	12,724	601	11,525	598	-
Equity index swaps	520	-	520	-	-	-	-	-	-	-
Currency derivatives										
Forward foreign exchange contracts	180,643	157,456	23,187	-	-	160,540	155,989	4,551	-	-
Others										
Stock index futures contracts	32,664	32,664	-	-	-	17,029	17,029	-	-	-
Bond futures contracts	7,818	7,818	-	-	-	5,923	5,923	-	-	-
Bond options contracts	-	-	-	-	-	3,102	3,102	-	-	-
<b>TOTAL</b>	<b>240,760</b>	<b>198,576</b>	<b>26,626</b>	<b>7,593</b>	<b>7,965</b>	<b>241,947</b>	<b>182,644</b>	<b>16,076</b>	<b>34,451</b>	<b>8,776</b>

## 9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Fund	
	2010	2009	2010	2009
At fair value				
<b>Debt securities</b>				
<b>Treasury bills and commercial paper</b>				
Listed outside Hong Kong	44	3,324	44	3,324
Unlisted	846,014	873,782	846,014	873,782
<b>Other debt securities</b>				
Listed outside Hong Kong	486,515	403,258	485,184	403,258
Unlisted	378,484	357,240	375,413	357,240
<b>Total debt securities</b>	<b>1,711,057</b>	<b>1,637,604</b>	<b>1,706,655</b>	<b>1,637,604</b>
<b>Equity securities</b>				
Listed in Hong Kong	152,572	142,939	152,572	142,939
Listed outside Hong Kong	190,880	168,180	190,880	168,180
Unlisted	54,455	46,741	54,455	46,741
<b>Total equity securities</b>	<b>397,907</b>	<b>357,860</b>	<b>397,907</b>	<b>357,860</b>
<b>TOTAL</b>	<b>2,108,964</b>	<b>1,995,464</b>	<b>2,104,562</b>	<b>1,995,464</b>

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 10 AVAILABLE-FOR-SALE SECURITIES

	Group		Fund	
	2010	2009	2010	2009
<b>Debt securities, at fair value</b>				
Listed in Hong Kong	-	78	-	-
Listed outside Hong Kong	-	57	-	-
Unlisted	<b>1,435</b>	2,452	-	-
	<b>1,435</b>	2,587	-	-
<b>Equity securities</b>				
Listed in Hong Kong, at fair value	<b>1,469</b>	1,026	-	-
Unlisted, at cost	<b>493</b>	493	<b>493</b>	493
	<b>1,962</b>	1,519	<b>493</b>	493
<b>Investment funds, at fair value</b>				
Unlisted	<b>8,929</b>	3,572	-	-
<b>TOTAL</b>	<b>12,326</b>	7,678	<b>493</b>	493

The Group's investment in unlisted equity securities as at 31 December 2010 represents a holding of 4,285 shares (2009: 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 32(a)). Fair value has not been ascertained for these shares as they are not freely transferable.

## 11 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2010	2009	2010	2009
At amortised cost				
<b>Debt securities</b>				
Listed in Hong Kong	<b>1,014</b>	1,167	-	-
Listed outside Hong Kong	<b>3,025</b>	2,244	-	-
Unlisted	<b>4,069</b>	2,472	-	-
<b>TOTAL</b>	<b>8,108</b>	5,883	-	-

## Exchange Fund – Notes to the Financial Statements (continued)

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

### 12 LOAN PORTFOLIO

	Group		Fund	
	2010	2009	2010	2009
Mortgage loans, at amortised cost	<b>34,711</b>	42,736	-	-
Non-mortgage loans, at amortised cost	<b>550</b>	1,067	-	-
Allowance for loan impairment	<b>(2)</b>	(14)	-	-
<b>TOTAL</b>	<b>35,259</b>	43,789	-	-

### 13 GOLD

	Group and Fund	
	2010	2009
Gold, at market value 66,798 ounces (2009: 66,798 ounces)	<b>732</b>	572

### 14 OTHER ASSETS

	Group		Fund	
	2010	2009	2010	2009
Interest and dividends receivable	<b>9,896</b>	9,996	<b>9,158</b>	9,323
Unsettled sales and redemption of securities	<b>7,782</b>	3,698	<b>7,782</b>	3,698
Prepayments, receivables and other assets	<b>1,906</b>	1,122	<b>1,642</b>	739
Staff housing loans	<b>188</b>	247	<b>188</b>	247
<b>TOTAL</b>	<b>19,772</b>	15,063	<b>18,770</b>	14,007

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2010	2009
Unlisted shares, at cost	2,145	2,145
Loans to subsidiaries	14,683	2,802
<b>TOTAL</b>	<b>16,828</b>	4,947

The following is a list of the principal subsidiaries as at 31 December 2010:

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%
Bauhinia HKMC Corporation Limited	People's Republic of China	Mortgage guarantee business	RMB100,000,000	90%
Eight Finance Investment Company Limited	Hong Kong	Investment holding	HK\$1	100%
Drawbridge Investment Limited	Hong Kong	Investment holding	HK\$1	100%
Debt Capital Solutions Company Limited	Hong Kong	Investment holding	HK\$1	100%
Real Gate Investment Company Limited	Hong Kong	Investment properties holding	HK\$1	100%

The Hong Kong Mortgage Corporation Limited has unissued authorised share capital of HK\$1 billion (2009: HK\$1 billion), which is callable from the Fund.

Loans to subsidiaries with principal activities for holding investment including properties are unsecured, interest-free loans and repayable on demand.



# Exchange Fund – Notes to the Financial Statements (continued)

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

## 16 INTERESTS IN ASSOCIATE AND JOINT VENTURES

	Group		Fund	
	2010	2009	2010	2009
<b>Associate</b>				
Unlisted shares, at cost	-	-	-	-
Share of net assets	47	45	-	-
	<b>47</b>	45	-	-
<b>Joint ventures</b>				
Unlisted shares, at cost	120	120	-	-
Due from joint ventures	3,443	-	-	-
Share of net assets	(154)	2	-	-
Foreign currency translation differences	5	(7)	-	-
	<b>3,414</b>	115	-	-
<b>TOTAL</b>	<b>3,461</b>	160	-	-

The Fund holds directly an associate incorporated in Hong Kong (issued share capital: HK\$10,000) which provides interbank clearing services. The Fund holds 50% (2009: 50%) of equity interest.

The Group holds investments in joint ventures through the following subsidiaries:

- the HKMC which holds a joint venture incorporated outside Hong Kong for providing mortgage guarantee coverage to banks. The HKMC holds 50% (2009: 50%) of equity interest; and
- Real Gate Investment Company Limited (RG) which holds two joint ventures incorporated outside Hong Kong for holding overseas investment properties. RG holds 51% (2009: Nil) and 74% (2009: Nil) of equity interests in these joint ventures respectively.

The Group's share of the joint ventures is summarised below:

	Group	
	2010	2009
Current assets	455	116
Non-current assets	7,996	-
Current liabilities	84	1
Non-current liabilities	4,953	-
Share of income	31	3
Share of expenses	187	1

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 17 PROPERTY, PLANT AND EQUIPMENT

(a)

	Group			
	Premises (restated)	Plant and equipment	Computer software licences and system development costs	Total (restated)
<b>Cost</b>				
At 1 January 2009	3,855	666	246	4,767
Additions	–	89	6	95
Disposals	(3)	(7)	–	(10)
At 31 December 2009	3,852	748	252	4,852
At 1 January 2010	<b>3,852</b>	<b>748</b>	<b>252</b>	<b>4,852</b>
Additions	–	<b>47</b>	<b>10</b>	<b>57</b>
Disposals	–	<b>(34)</b>	–	<b>(34)</b>
At 31 December 2010	<b>3,852</b>	<b>761</b>	<b>262</b>	<b>4,875</b>
<b>Accumulated depreciation</b>				
At 1 January 2009	457	429	231	1,117
Charge for the year	88	47	5	140
Written back on disposal	(1)	(7)	–	(8)
At 31 December 2009	544	469	236	1,249
At 1 January 2010	<b>544</b>	<b>469</b>	<b>236</b>	<b>1,249</b>
Charge for the year	<b>89</b>	<b>55</b>	<b>4</b>	<b>148</b>
Written back on disposal	–	<b>(23)</b>	–	<b>(23)</b>
At 31 December 2010	<b>633</b>	<b>501</b>	<b>240</b>	<b>1,374</b>
<b>Net book value</b>				
<b>At 31 December 2010</b>	<b>3,219</b>	<b>260</b>	<b>22</b>	<b>3,501</b>
At 31 December 2009	3,308	279	16	3,603

## Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund			Total (restated)
	Premises (restated)	Plant and equipment	Computer software licences and system development costs	
<b>Cost</b>				
At 1 January 2009	3,843	224	246	4,313
Additions	–	26	6	32
Disposals	–	(6)	–	(6)
At 31 December 2009	3,843	244	252	4,339
At 1 January 2010	<b>3,843</b>	<b>244</b>	<b>252</b>	<b>4,339</b>
Additions	–	<b>34</b>	<b>10</b>	<b>44</b>
Disposals	–	<b>(10)</b>	–	<b>(10)</b>
At 31 December 2010	<b>3,843</b>	<b>268</b>	<b>262</b>	<b>4,373</b>
<b>Accumulated depreciation</b>				
At 1 January 2009	453	181	231	865
Charge for the year	88	13	5	106
Written back on disposal	–	(6)	–	(6)
At 31 December 2009	541	188	236	965
At 1 January 2010	<b>541</b>	<b>188</b>	<b>236</b>	<b>965</b>
Charge for the year	<b>88</b>	<b>18</b>	<b>4</b>	<b>110</b>
Written back on disposal	–	<b>(10)</b>	–	<b>(10)</b>
At 31 December 2010	<b>629</b>	<b>196</b>	<b>240</b>	<b>1,065</b>
<b>Net book value</b>				
<b>At 31 December 2010</b>	<b>3,214</b>	<b>72</b>	<b>22</b>	<b>3,308</b>
At 31 December 2009	3,302	56	16	3,374

**(b) The net book value of premises comprises:**

	Group		Fund	
	2010	2009 (restated)	2010	2009 (restated)
In Hong Kong				
Leasehold land and the building situated thereon (leasehold between 10 and 50 years)	<b>3,196</b>	3,285	<b>3,191</b>	3,279
Outside Hong Kong				
Freehold land and the building situated thereon	<b>23</b>	23	<b>23</b>	23
<b>TOTAL</b>	<b>3,219</b>	3,308	<b>3,214</b>	3,302

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 18 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	
	2010	2009	2010	2009
Carrying amount	<b>225,939</b>	199,006	<b>8,899</b>	8,427
<b>Reconciliation with face value:</b>				
Hong Kong dollar face value	<b>226,705</b>	200,185	<b>8,929</b>	8,477
Linked exchange rate for calculating the US dollars required for redemption	<b>US\$1 = HK\$7.80</b>	US\$1 = HK\$7.80	<b>US\$1 = HK\$7.80</b>	US\$1 = HK\$7.80
US dollars required for redemption	<b>US\$29,065 million</b>	US\$25,665 million	<b>US\$1,145 million</b>	US\$1,087 million
Market exchange rate for translation into Hong Kong dollars	<b>US\$1 = HK\$7.77365</b>	US\$1 = HK\$7.75405	<b>US\$1 = HK\$7.77365</b>	US\$1 = HK\$7.75405
Carrying amount	<b>225,939</b>	199,006	<b>8,899</b>	8,427

## 19 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 (continued)

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

## 20 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2010	2009
At amortised cost		
Placements by central banks	<b>23,187</b>	–
Placements by banks	–	28,311
<b>TOTAL</b>	<b>23,187</b>	28,311

## 21 PLACEMENTS BY FISCAL RESERVES

	Group and Fund	
	2010	2009
<b>Placements with interest payable at a fixed rate determined annually</b>		
General Revenue Account	<b>309,168</b>	269,867
Land Fund	<b>186,925</b>	175,846
Capital Works Reserve Fund	<b>56,859</b>	22,026
Civil Service Pension Reserve Fund	<b>22,994</b>	21,631
Disaster Relief Fund	<b>47</b>	22
Innovation and Technology Fund	<b>3,444</b>	3,971
Lotteries Fund	<b>8,459</b>	7,832
Capital Investment Fund	<b>2,163</b>	820
Loan Fund	<b>2,071</b>	1,821
	<b>592,130</b>	503,836
<b>Placements with interest payable at market-based rates</b>		
General Revenue Account	<b>152</b>	276
Capital Works Reserve Fund	–	11
	<b>152</b>	287
<b>TOTAL</b>	<b>592,282</b>	504,123

Placements by Fiscal Reserves are repayable on demand. 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 (2009: 6.8%).

## Exchange Fund – Notes to the Financial Statements (continued)

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

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

	Group and Fund	
	2010	2009
<b>Placements with interest payable at a fixed rate determined annually</b>		
Research Endowment Fund	19,451	15,805
Bond Fund	25,088	5,631
Housing Authority	21,620	20,339
West Kowloon Cultural District Authority	10,503	–
	<b>76,662</b>	41,775
<b>Placements with interest payable at market-based rates</b>		
Deposit Protection Scheme Fund	98	61
<b>TOTAL</b>	<b>76,760</b>	41,836

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 (2009: 6.8%).

### 23 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group		Fund	
	2010	2009	2010	2009
At fair value				
<b>Exchange Fund Bills and Notes issued</b>				
Exchange Fund Bills	582,967	464,304	582,967	464,304
Exchange Fund Notes	72,253	73,125	72,253	73,125
	<b>655,220</b>	537,429	<b>655,220</b>	537,429
<b>Exchange Fund Bills held</b>	<b>(1,499)</b>	(1,000)	<b>(999)</b>	(1,000)
<b>TOTAL</b>	<b>653,721</b>	536,429	<b>654,221</b>	536,429

## Exchange Fund – Notes to the Financial Statements (continued)

(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 the “HKMA EFBN Closing Reference” 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.

The analysis of the nominal value of EFBN issued at the beginning and the end of year is set out below:

	Group				Fund			
	2010		2009		2010		2009	
	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes	Exchange Fund Bills	Exchange Fund Notes
Issued by Currency Board Operations segment								
Nominal value at 1 January	464,362	69,700	90,753	66,900	464,362	69,700	90,753	66,900
Issuance	1,800,352	16,400	1,031,328	16,400	1,800,352	16,400	1,031,328	16,400
Redemption	(1,681,476)	(16,200)	(657,719)	(13,600)	(1,681,476)	(16,200)	(657,719)	(13,600)
Nominal value at 31 December	583,238	69,900	464,362	69,700	583,238	69,900	464,362	69,700
Long positions held by Financial Stability and Other Activities segment								
Nominal value at 31 December	(1,500)	-	(1,000)	-	(1,000)	-	(1,000)	-
Total nominal value	581,738	69,900	463,362	69,700	582,238	69,900	463,362	69,700
Carrying amount, at fair value	581,468	72,253	463,304	73,125	581,968	72,253	463,304	73,125
Difference	270	(2,353)	58	(3,425)	270	(2,353)	58	(3,425)

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

## Exchange Fund – Notes to the Financial Statements (continued)

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

### 24 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2010	2009	2010	2009
Debt securities issued, carried at amortised cost	<b>4,119</b>	4,218	-	-
Debt securities issued, designated as fair value hedge	<b>33,044</b>	37,395	-	-
Debt securities issued, designated at fair value	<b>1,937</b>	2,846	-	-
<b>TOTAL</b>	<b>39,100</b>	44,459	-	-

The analysis of the nominal value of other debt securities issued at the beginning and the end of year is set out below:

	Group		Fund	
	2010	2009	2010	2009
Total debt securities issued				
Nominal value at 1 January	<b>43,989</b>	40,939	-	-
Issuance	<b>8,280</b>	22,689	-	-
Redemption	<b>(13,831)</b>	(19,652)	-	-
Foreign currency translation difference	<b>5</b>	13	-	-
Nominal value at 31 December	<b>38,443</b>	43,989	-	-
Carrying amount	<b>39,100</b>	44,459	-	-
Difference	<b>(657)</b>	(470)	-	-
Debt securities issued, designated at fair value				
Nominal value	<b>2,549</b>	3,427	-	-
Carrying amount, at fair value	<b>1,937</b>	2,846	-	-
Difference	<b>612</b>	581	-	-

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 (continued)

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

### 25 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2010	2009	2010	2009
Mortgage-backed securities issued, carried at amortised cost	<b>806</b>	1,051	-	-
Mortgage-backed securities issued, designated as fair value hedge	<b>724</b>	970	-	-
<b>TOTAL</b>	<b>1,530</b>	2,021	-	-

The analysis of the nominal value of mortgage-backed securities issued at the beginning and the end of year is set out below:

	Group		Fund	
	2010	2009	2010	2009
Total mortgage-backed securities issued				
Nominal value at 1 January	<b>1,976</b>	3,148	-	-
Redemption	<b>(470)</b>	(1,172)	-	-
Nominal value at 31 December	<b>1,506</b>	1,976	-	-
Carrying amount	<b>1,530</b>	2,021	-	-
Difference	<b>(24)</b>	(45)	-	-

### 26 OTHER LIABILITIES

	Group		Fund	
	2010	2009	2010	2009
Unsettled purchases of securities	<b>20,284</b>	11,428	<b>20,284</b>	11,428
Accrued charges and other liabilities	<b>6,608</b>	6,321	<b>451</b>	568
Interest payable	<b>821</b>	819	<b>327</b>	373
Tax payable	<b>142</b>	138	-	-
Deferred tax liabilities	<b>64</b>	47	-	-
<b>TOTAL</b>	<b>27,919</b>	18,753	<b>21,062</b>	12,369

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 27 EQUITY

	Group		Fund	
	2010	2009	2010	2009
<b>Attributable to owner of the Fund</b>				
<b>Accumulated surplus</b>				
At 1 January	558,220	484,461	553,457	480,485
Surplus for the year	39,333	73,759	38,046	72,972
At 31 December	597,553	558,220	591,503	553,457
<b>Other reserves</b>				
Revaluation reserve				
At 1 January	865	(88)	-	-
Fair value changes on available-for-sale securities:				
– revaluation	1,248	973	-	-
– realisation on disposal	(40)	(4)	-	-
– tax effect	(17)	(37)	-	-
Cash flow hedges:				
– revaluation	26	25	-	-
– tax effect	(4)	(4)	-	-
At 31 December	2,078	865	-	-
Translation reserve				
At 1 January	(7)	(9)	-	-
Currency translation differences:				
– subsidiaries and joint ventures	48	2	-	-
At 31 December	41	(7)	-	-
	2,119	858	-	-
	599,672	559,078	591,503	553,457
<b>Non-controlling interests</b>				
At 1 January	204	191	-	-
Total comprehensive income for the year	12	15	-	-
Capital injection by non-controlling interests	67	11	-	-
Dividends paid to non-controlling interests	(11)	(13)	-	-
At 31 December	272	204	-	-
<b>TOTAL</b>	<b>599,944</b>	<b>559,282</b>	<b>591,503</b>	<b>553,457</b>

## Exchange Fund – Notes to the Financial Statements (continued)

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

### 28 ANALYSIS OF CASH AND CASH EQUIVALENTS IN THE STATEMENT OF CASH FLOWS

	Group		Fund	
	2010	2009	2010	2009
Cash and money at call	<b>49,579</b>	17,736	<b>48,911</b>	17,658
Placements with banks and other financial institutions	<b>153,260</b>	110,898	<b>148,700</b>	107,105
Treasury bills and commercial paper	<b>9,625</b>	79,486	<b>9,625</b>	79,486
<b>TOTAL</b>	<b>212,464</b>	208,120	<b>207,236</b>	204,249

#### Reconciliation with the balance sheet

	Note	Group		Fund	
		2010	2009	2010	2009
<b>Amounts shown in the balance sheet</b>					
Cash and money at call	6	<b>49,579</b>	17,736	<b>48,911</b>	17,658
Placements with banks and other financial institutions	7	<b>155,455</b>	112,732	<b>149,478</b>	108,636
Financial assets designated at fair value					
Treasury bills and commercial paper	9	<b>846,058</b>	877,106	<b>846,058</b>	877,106
		<b>1,051,092</b>	1,007,574	<b>1,044,447</b>	1,003,400
Less: Amounts with original maturity beyond 3 months		<b>(838,628)</b>	(799,454)	<b>(837,211)</b>	(799,151)
<b>Cash and cash equivalents in the statement of cash flows</b>		<b>212,464</b>	208,120	<b>207,236</b>	204,249

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 29 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 2.17.

	Group									
	Currency Board Operations		Reserves Management		Currency Board Operations and Reserves Management		Financial Stability and Other Activities		Total	
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
<b>Income/(Loss)</b>	<b>12,555</b>	(1,441)	<b>67,931</b>	112,404	<b>80,486</b>	110,963	<b>2,076</b>	1,940	<b>82,562</b>	112,903
<b>Expenditure</b>										
Interest expense	<b>1,815</b>	940	<b>37,846</b>	34,844	<b>39,661</b>	35,784	<b>172</b>	279	<b>39,833</b>	36,063
Other expenses (note 29(b))	-	-	-	-	<b>1,548</b>	1,447	<b>1,504</b>	1,471	<b>3,052</b>	2,918
	<b>1,815</b>	940	<b>37,846</b>	34,844	<b>41,209</b>	37,231	<b>1,676</b>	1,750	<b>42,885</b>	38,981
<b>Surplus/(Deficit) before share of profit/(loss) of associate and joint ventures</b>	<b>10,740</b>	(2,381)	<b>30,085</b>	77,560	<b>39,277</b>	73,732	<b>400</b>	190	<b>39,677</b>	73,922
Share of profit/(loss) of associate and joint ventures, net of tax	-	-	<b>(158)</b>	-	<b>(158)</b>	-	<b>4</b>	2	<b>(154)</b>	2
<b>Surplus/(Deficit) before taxation</b>	<b>10,740</b>	(2,381)	<b>29,927</b>	77,560	<b>39,119</b>	73,732	<b>404</b>	192	<b>39,523</b>	73,924
Income tax	-	-	-	-	-	-	<b>(178)</b>	(150)	<b>(178)</b>	(150)
<b>Surplus/(Deficit) for the year</b>	<b>10,740</b>	(2,381)	<b>29,927</b>	77,560	<b>39,119</b>	73,732	<b>226</b>	42	<b>39,345</b>	73,774
<b>Attributable to:</b>										
Owner of the Fund	<b>10,740</b>	(2,381)	<b>29,930</b>	77,560	<b>39,122</b>	73,732	<b>211</b>	27	<b>39,333</b>	73,759
Non-controlling interests	-	-	<b>(3)</b>	-	<b>(3)</b>	-	<b>15</b>	15	<b>12</b>	15
	<b>10,740</b>	(2,381)	<b>29,927</b>	77,560	<b>39,119</b>	73,732	<b>226</b>	42	<b>39,345</b>	73,774

# Exchange Fund – Notes to the Financial Statements (continued)

(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 29(c) & (d))		Total	
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
<b>Assets</b>												
Backing Assets												
Investment in designated US dollar assets	1,119,691	1,079,351	-	-	1,119,691	1,079,351	-	-	-	-	1,119,691	1,079,351
Interest receivable on designated US dollar assets	1,404	1,738	-	-	1,404	1,738	-	-	-	-	1,404	1,738
Other investments	-	-	1,142,354	1,043,672	1,142,354	1,043,672	113,338	61,991	(1,499)	(1,000)	1,254,193	1,104,663
Other assets	-	-	18,526	15,742	18,526	15,742	6,101	6,279	541	472	25,168	22,493
<b>TOTAL ASSETS</b>	<b>1,121,095</b>	<b>1,081,089</b>	<b>1,160,880</b>	<b>1,059,414</b>	<b>2,281,975</b>	<b>2,140,503</b>	<b>119,439</b>	<b>68,270</b>	<b>(958)</b>	<b>(528)</b>	<b>2,400,456</b>	<b>2,208,245</b>
<b>Liabilities</b>												
Monetary Base												
Certificates of Indebtedness	225,939	199,006	-	-	225,939	199,006	-	-	-	-	225,939	199,006
Government-issued currency notes and coins in circulation	8,899	8,427	-	-	8,899	8,427	-	-	-	-	8,899	8,427
Balance of the banking system	148,702	264,567	-	-	148,702	264,567	-	-	-	-	148,702	264,567
Exchange Fund Bills and Notes issued	655,220	537,429	-	-	655,220	537,429	-	-	(1,499)	(1,000)	653,721	536,429
Interest payable on Exchange Fund Notes	327	373	-	-	327	373	-	-	-	-	327	373
Net accounts (receivable)/payable	(355)	(336)	-	-	(355)	(336)	-	-	541	472	186	136
Other debt securities issued	-	-	-	-	-	-	39,100	44,459	-	-	39,100	44,459
Mortgage-backed securities issued	-	-	-	-	-	-	1,530	2,021	-	-	1,530	2,021
Placements by banks and other financial institutions	-	-	-	28,311	-	28,311	23,187	-	-	-	23,187	28,311
Placements by Fiscal Reserves	-	-	592,282	504,123	592,282	504,123	-	-	-	-	592,282	504,123
Placements by HKSAR government funds and statutory bodies	-	-	76,662	41,775	76,662	41,775	98	61	-	-	76,760	41,836
Other liabilities	-	-	22,495	12,615	22,495	12,615	7,384	6,660	-	-	29,879	19,275
<b>Total liabilities</b>	<b>1,038,732</b>	<b>1,009,466</b>	<b>691,439</b>	<b>586,824</b>	<b>1,730,171</b>	<b>1,596,290</b>	<b>71,299</b>	<b>53,201</b>	<b>(958)</b>	<b>(528)</b>	<b>1,800,512</b>	<b>1,648,963</b>

# Exchange Fund – Notes to the Financial Statements (continued)

(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 29(c) & (d))		Total	
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
<b>Accumulated surplus</b>												
At 1 January	71,623	49,207	471,847	408,352	543,470	457,559	14,750	26,902	-	-	558,220	484,461
Surplus/(Deficit) for the year attributable to owner of the Fund	10,740	(2,381)	29,930	77,560	39,122	73,732	211	27	-	-	39,333	73,759
Transfer between Currency Board Operations and general reserves (note 29(e))	-	24,797	(34,278)	(14,065)	(32,730)	12,179	32,730	(12,179)	-	-	-	-
At 31 December	82,363	71,623	467,499	471,847	549,862	543,470	47,691	14,750	-	-	597,553	558,220
<b>Other reserves</b>	-	-	1,878	743	1,878	743	241	115	-	-	2,119	858
<b>Non-controlling interests</b>	-	-	64	-	64	-	208	204	-	-	272	204
<b>Total equity</b>	82,363	71,623	469,441	472,590	551,804	544,213	48,140	15,069	-	-	599,944	559,282
<b>TOTAL LIABILITIES AND EQUITY</b>	1,121,095	1,081,089	1,160,880	1,059,414	2,281,975	2,140,503	119,439	68,270	(958)	(528)	2,400,456	2,208,245

## (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 the Currency Board Operations segment and the Reserves Management segment are aggregated as there is no meaningful basis to allocate such expenses between these two segments.

## Exchange Fund – Notes to the Financial Statements (continued)

(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 2010, deductions from the Monetary Base comprised “other assets” of HK\$541 million (2009: HK\$472 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\$22 million (2009: HK\$19 million) and revaluation gains of HK\$519 million (2009: HK\$453 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 (continued)

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

### 30 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.

	Note	Group		Fund	
		2010	2009	2010	2009
<b>Secured liabilities</b>					
Stock index futures contracts – notional amount	8(b)	<b>32,664</b>	17,029	<b>32,664</b>	17,029
Bond futures contracts – notional amount	8(b)	<b>7,818</b>	5,923	<b>7,818</b>	5,923
Interest rate futures contracts – notional amount	8(b)	<b>2,909</b>	12,724	<b>2,909</b>	12,724
Mortgage-backed securities issued	25	<b>1,530</b>	2,021	–	–
<b>Assets pledged</b>					
Financial assets designated at fair value		<b>3,385</b>	2,457	<b>3,385</b>	2,457
Held-to-maturity securities		<b>278</b>	–	–	–
Placements with banks		<b>28</b>	34	–	–
Mortgage loans		<b>1,185</b>	1,906	–	–

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 (continued)

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

## 31 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	
	2010	2009	2010	2009
Contracted for	1	8	1	8
Authorised but not yet contracted for	156	161	135	136
	157	169	136	144

### (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. As at 31 December 2010, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$4,070 million equivalent (2009: HK\$4,133 million equivalent), in the form of a five-year term loan bearing prevailing market interest rates. As at 31 December 2010, there was no outstanding balance due from the IMF under this NAB facility (2009: 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 (2009: 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 2010, there was no outstanding balance due from the HKDPB under this facility (2009: Nil). The standby credit facility has been increased to HK\$120 billion since 1 January 2011.

### (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 (2009: HK\$30 billion) at prevailing market interest rates. As at 31 December 2010, there was no outstanding balance due from the HKMC under this facility (2009: Nil).

# Exchange Fund – Notes to the Financial Statements (continued)

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

## (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\$44,699 million equivalent (2009: HK\$44,586 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2010, there was no outstanding transaction with any central bank under this arrangement (2009: Nil).

## (f) Chiang Mai Initiative Multilateralisation Agreement

Chiang Mai Initiative Multilateralisation (CMIM) Agreement came into effect on 24 March 2010. With a total size of US\$120 billion, the CMIM was established under the aegis of the 10 Association of Southeast Asian Nations (ASEAN) member countries together with China, Japan and Korea (ASEAN + 3) to provide short-term US dollars through currency swap transactions to participants facing balance-of-payments and liquidity difficulties. Hong Kong, through the HKMA, participates in the CMIM and has undertaken to commit up to US\$4.2 billion out of the Fund. Hong Kong has the right to request liquidity support up to US\$2.1 billion from the CMIM in case of emergency. Up to 31 December 2010, there had been no request to activate the CMIM.

## (g) Bilateral swap agreement

The HKMA and the People's Bank of China (PBoC) entered into a bilateral swap agreement in January 2009 to provide short-term liquidity support to the Mainland operations of Hong Kong banks and the Hong Kong operations of Mainland banks in case of need, and to promote the development of renminbi-denominated trade transactions between Hong Kong and the Mainland. This currency swap agreement has a term of three years and expires in January 2012, which can be extended upon agreement by both parties. It can provide liquidity support up to RMB200 billion/HK\$227 billion. The HKMA activated the currency swap agreement with the PBoC in 2010 for facilitating trade settlement business. The bilateral swap outstanding as at 31 December 2010 was RMB20 billion (2009: Nil).

## (h) Investment commitments

The Group's subsidiaries with principal activities for holding investment including properties had investment commitment of HK\$23,273 million equivalent as at 31 December 2010 (2009: HK\$9,351 million equivalent).

## (i) Lease commitments

As at 31 December 2010, the total future minimum lease payments payable under non-cancellable operating leases of premises were as follows:

	Group		Fund	
	2010	2009	2010	2009
Within one year	<b>34</b>	37	<b>33</b>	35
After one year but not later than five years	<b>35</b>	64	<b>35</b>	64
<b>TOTAL</b>	<b>69</b>	101	<b>68</b>	99

# Exchange Fund – Notes to the Financial Statements *(continued)*

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

## 32 CONTINGENT LIABILITIES

The Group has the following contingent liabilities:

- (a) as at 31 December 2010, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$192 million equivalent (2009: 16.1 million Special Drawing Rights or HK\$195 million equivalent), in respect of the uncalled portion of its 4,285 shares (2009: 4,285 shares) in the Bank for International Settlements (note 10); and
- (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 covered all protected deposits as defined in the Deposit Protection Scheme Ordinance (Cap. 581), were the Ordinance to apply to all authorized institutions including licensed banks, restricted licence banks and deposit-taking companies. It covered the amount of deposits in excess of the protection limit under the Deposit Protection Scheme Ordinance. This guarantee expired at the end of 2010 and had not been activated since its introduction in 2008. From 2011 onwards, the protection limit provided under the Deposit Protection Scheme Ordinance is HK\$0.5 million per depositor per bank.

## 33 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\$154 million (2009: HK\$173 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 (continued)

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

## 34 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.

### 34.1 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 (continued)

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

## 34.2 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 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 target asset and currency mix were as follows:

	2010	2009
<b>Asset type</b>		
Bonds	<b>75%</b>	75%
Equities and related investments	<b>25%</b>	25%
	<b>100%</b>	100%
<b>Currency<sup>1</sup></b>		
US dollar and other currencies	–	86%
Euro, yen, sterling and other currencies	–	14%
US dollar and Hong Kong dollar	<b>82%</b>	–
Others <sup>2</sup>	<b>18%</b>	–
	<b>100%</b>	100%

<sup>1</sup> Investments denominated in Australian dollar, Canadian dollar and Singapore dollar which were grouped under "US dollar and other currencies" in 2009 have been re-categorised under "Others" in 2010.

<sup>2</sup> These included investments denominated mainly in Australian dollar, Canadian dollar, Danish krone, euro, Norwegian krone, Singapore dollar, sterling, Swedish krona, Swiss franc and yen.

In addition to the investment benchmark, the EFAC determines the tactical deviation limits governing the extent to which the Fund's asset and currency mix 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 *(continued)*

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

## 34.3 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.

### 34.3.1 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.

In light of the increased volatility in financial markets, 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 (continued)

(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 (continued)

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

### 34.3.2 Exposure to credit risk

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

	Note	Group		Fund	
		2010	2009	2010	2009
Cash and money at call	6	<b>49,579</b>	17,736	<b>48,911</b>	17,658
Placements with banks and other financial institutions	7	<b>155,455</b>	112,732	<b>149,478</b>	108,636
Derivative financial instruments	8(a)	<b>3,299</b>	5,565	<b>1,902</b>	4,247
Debt securities designated at fair value	9	<b>1,711,057</b>	1,637,604	<b>1,706,655</b>	1,637,604
Available-for-sale debt securities	10	<b>1,435</b>	2,587	–	–
Held-to-maturity securities	11	<b>8,108</b>	5,883	–	–
Loan portfolio	12	<b>35,259</b>	43,789	–	–
Other assets	14	<b>19,772</b>	15,063	<b>18,770</b>	14,007
Loans to subsidiaries	15	–	–	<b>14,683</b>	2,802
Due from joint ventures	16	<b>3,443</b>	–	–	–
Mortgage insurance risk in force	34.6	<b>17,630</b>	14,921	–	–
Loan commitments and other credit related commitments		<b>144,691</b>	88,719	<b>151,418</b>	118,719
<b>TOTAL</b>		<b>2,149,728</b>	1,944,599	<b>2,091,817</b>	1,903,673

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 (continued)

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

## 34.3.3 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 2010, approximately 92% (2009: 95%) of the debt securities held by the Group were rated “triple-A” by rating agencies Moody’s or Standard & Poor’s. The credit quality of major financial assets is analysed below:

	Group		Fund	
	2010	2009	2010	2009
<b>Cash and money at call, placements with banks and other financial institutions, by credit rating<sup>1</sup></b>				
AAA	<b>39,487</b>	40,107	<b>39,487</b>	40,107
AA – to AA +	<b>69,720</b>	32,035	<b>68,800</b>	28,083
A – to A +	<b>71,024</b>	57,411	<b>65,591</b>	57,191
Lower than A– or un-rated <sup>2</sup>	<b>24,803</b>	915	<b>24,511</b>	913
	<b>205,034</b>	130,468	<b>198,389</b>	126,294
<b>Debt securities, by credit rating<sup>1</sup></b>				
AAA	<b>1,590,105</b>	1,563,347	<b>1,586,920</b>	1,562,078
AA – to AA +	<b>59,139</b>	28,629	<b>53,154</b>	22,273
A – to A +	<b>12,752</b>	5,561	<b>12,379</b>	4,716
Lower than A– or un-rated <sup>2</sup>	<b>58,604</b>	48,537	<b>54,202</b>	48,537
	<b>1,720,600</b>	1,646,074	<b>1,706,655</b>	1,637,604
<b>Loan portfolio</b>				
Neither past due nor impaired (note 34.3.3(a))	<b>34,648</b>	42,855	–	–
Past due but not impaired (note 34.3.3(b))	<b>613</b>	943	–	–
Impaired (note 34.3.3(c))	–	5	–	–
Allowance for loan impairment	<b>(2)</b>	(14)	–	–
	<b>35,259</b>	43,789	–	–
<b>TOTAL</b>	<b>1,960,893</b>	1,820,331	<b>1,905,044</b>	1,763,898

<sup>1</sup> This is the lower of ratings designated by Moody’s and Standard & Poor’s.

<sup>2</sup> These include mainly balance with central banks and debt securities issued by the Bank for International Settlements which are not rated.

## Exchange Fund – Notes to the Financial Statements (continued)

(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 levels of credit enhancements in addition to the collateral. Grade 4 includes loans with past due experience and with different levels of credit enhancements in addition to the collateral. Grade 5 includes loans with past due experience and collateral but without further credit enhancement. The credit quality of loans that were neither past due nor impaired at the balance sheet date is analysed below:

	Group		Fund	
	2010	2009	2010	2009
Grades				
1 to 3	34,621	42,794	-	-
4	-	-	-	-
5	27	61	-	-
<b>TOTAL</b>	<b>34,648</b>	<b>42,855</b>	<b>-</b>	<b>-</b>

### (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 loans that were past due but not impaired at the balance sheet date are analysed below:

	Group		Fund	
	2010	2009	2010	2009
Loans that were past due				
90 days or less	610	933	-	-
91 to 180 days	2	5	-	-
over 180 days	1	5	-	-
<b>TOTAL</b>	<b>613</b>	<b>943</b>	<b>-</b>	<b>-</b>
Fair value of collateral and other credit enhancements	2,529	2,753	-	-

# Exchange Fund – Notes to the Financial Statements (continued)

(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. As at 31 December 2010, the fair value of related collateral held and credit enhancement was HK\$0.4 million (2009: HK\$9 million).

### 34.3.4 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 maximum credit risk exposure (note 34.3.2) by industry groups is analysed below:

	Group		Fund	
	2010	2009	2010	2009
Governments and government agencies <sup>1</sup>	<b>1,677,684</b>	1,631,417	<b>1,676,894</b>	1,631,104
Supra-nationals	<b>82,472</b>	42,012	<b>82,449</b>	41,967
States, provinces and public-sector entities <sup>2</sup>	<b>73,105</b>	41,764	<b>102,241</b>	70,913
Financial institutions	<b>152,899</b>	103,125	<b>139,144</b>	92,559
Others	<b>163,568</b>	126,281	<b>91,089</b>	67,130
<b>TOTAL</b>	<b>2,149,728</b>	1,944,599	<b>2,091,817</b>	1,903,673

<sup>1</sup> These include debt securities guaranteed by governments.

<sup>2</sup> These include debt securities guaranteed by states.

## 34.4 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.

### 34.4.1 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 (continued)

(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, 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.

### 34.4.2 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 (continued)

(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 (continued)

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

### 34.4.3 Exposure to market risk

#### (a) Interest rate risk

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 is shown below. The assets and liabilities are stated at carrying amounts at the balance sheet date and categorised by the earlier of contractual repricing dates or maturity dates.

	Group – 2010							Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments							
	1 month or less	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	Total	
<b>Assets</b>								
Cash and money at call	25,826	-	-	-	-	-	25,826	23,753
Placements with banks and other financial institutions	153,942	1,214	299	-	-	-	155,455	-
Financial assets designated at fair value	166,953	288,766	472,154	412,025	220,360	146,118	1,706,376	402,588
Available-for-sale securities	490	945	-	-	-	-	1,435	10,891
Held-to-maturity securities	349	77	719	4,282	2,681	-	8,108	-
Loan portfolio	25,697	9,346	141	54	21	-	35,259	-
<b>Interest-bearing assets</b>	<b>373,257</b>	<b>300,348</b>	<b>473,313</b>	<b>416,361</b>	<b>223,062</b>	<b>146,118</b>	<b>1,932,459</b>	
<b>Liabilities</b>								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	23,187
Placements by Fiscal Reserves with interest payable at market-based rates <sup>1</sup>	152	-	-	-	-	-	152	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates <sup>1</sup>	98	-	-	-	-	-	98	-
Exchange Fund Bills and Notes issued	133,239	318,415	147,091	42,440	8,368	4,168	653,721	-
Other debt securities issued	6,863	4,863	9,276	13,052	3,776	1,270	39,100	-
Mortgage-backed securities issued	806	724	-	-	-	-	1,530	-
<b>Interest-bearing liabilities</b>	<b>141,158</b>	<b>324,002</b>	<b>156,367</b>	<b>55,492</b>	<b>12,144</b>	<b>5,438</b>	<b>694,601</b>	
<b>Interest rate derivatives (net position, notional amounts)</b>	<b>(12,049)</b>	<b>(23,868)</b>	<b>12,428</b>	<b>11,250</b>	<b>8,892</b>	<b>3,600</b>	<b>253</b>	
<b>Interest rate sensitivity gap</b>	<b>220,050</b>	<b>(47,522)</b>	<b>329,374</b>	<b>372,119</b>	<b>219,810</b>	<b>144,280</b>	<b>1,238,111</b>	

<sup>1</sup> 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 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).

# Exchange Fund – Notes to the Financial Statements (continued)

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

	Group – 2009							Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments							
	1 month or less	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	Total	
<b>Assets</b>								
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	-
<b>Interest-bearing assets</b>	<b>306,302</b>	<b>278,590</b>	<b>555,116</b>	<b>311,073</b>	<b>215,767</b>	<b>149,793</b>	<b>1,816,641</b>	
<b>Liabilities</b>								
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311	-
Placements by Fiscal Reserves with interest payable at market-based rates <sup>1</sup>	287	-	-	-	-	-	287	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates <sup>1</sup>	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	-
<b>Interest-bearing liabilities</b>	<b>125,065</b>	<b>274,461</b>	<b>129,221</b>	<b>65,603</b>	<b>12,260</b>	<b>4,958</b>	<b>611,568</b>	
<b>Interest rate derivatives (net position, notional amounts)</b>	<b>(13,406)</b>	<b>11,476</b>	<b>2,617</b>	<b>(6,976)</b>	<b>3,983</b>	<b>2,400</b>	<b>94</b>	
<b>Interest rate sensitivity gap</b>	<b>167,831</b>	<b>15,605</b>	<b>428,512</b>	<b>238,494</b>	<b>207,490</b>	<b>147,235</b>	<b>1,205,167</b>	

<sup>1</sup> 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 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).

# Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2010							Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments							
	1 month or less	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	Total	
<b>Assets</b>								
Cash and money at call	25,210	-	-	-	-	-	25,210	23,701
Placements with banks and other financial institutions	148,700	778	-	-	-	-	149,478	-
Financial assets designated at fair value	165,398	288,078	472,115	411,480	219,589	146,103	1,702,763	401,799
<b>Interest-bearing assets</b>	<b>339,308</b>	<b>288,856</b>	<b>472,115</b>	<b>411,480</b>	<b>219,589</b>	<b>146,103</b>	<b>1,877,451</b>	
<b>Liabilities</b>								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	23,187
Placements by Fiscal Reserves with interest payable at market-based rates <sup>1</sup>	152	-	-	-	-	-	152	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates <sup>1</sup>	98	-	-	-	-	-	98	-
Exchange Fund Bills and Notes issued	133,739	318,415	147,091	42,440	8,368	4,168	654,221	-
<b>Interest-bearing liabilities</b>	<b>133,989</b>	<b>318,415</b>	<b>147,091</b>	<b>42,440</b>	<b>8,368</b>	<b>4,168</b>	<b>654,471</b>	
<b>Interest rate derivatives (net position, notional amounts)</b>	<b>-</b>	<b>(10,045)</b>	<b>3,321</b>	<b>(1,241)</b>	<b>4,365</b>	<b>3,600</b>	<b>-</b>	
<b>Interest rate sensitivity gap</b>	<b>205,319</b>	<b>(39,604)</b>	<b>328,345</b>	<b>367,799</b>	<b>215,586</b>	<b>145,535</b>	<b>1,222,980</b>	

<sup>1</sup> 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 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).



# Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2009							Total	Non-interest-bearing financial instruments
	Repricing period of interest-bearing financial instruments								
	1 month or less	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			
<b>Assets</b>									
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	
<b>Interest-bearing assets</b>	<b>264,303</b>	<b>269,322</b>	<b>553,705</b>	<b>307,874</b>	<b>215,276</b>	<b>149,793</b>	<b>1,760,273</b>		
<b>Liabilities</b>									
Placements by banks and other financial institutions	28,311	-	-	-	-	-	28,311	-	
Placements by Fiscal Reserves with interest payable at market-based rates <sup>1</sup>	287	-	-	-	-	-	287	-	
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates <sup>1</sup>	61	-	-	-	-	-	61	-	
Exchange Fund Bills and Notes issued	89,312	268,167	122,334	45,203	8,257	3,156	536,429	-	
<b>Interest-bearing liabilities</b>	<b>117,971</b>	<b>268,167</b>	<b>122,334</b>	<b>45,203</b>	<b>8,257</b>	<b>3,156</b>	<b>565,088</b>		
<b>Interest rate derivatives (net position, notional amounts)</b>	<b>-</b>	<b>24,930</b>	<b>(99)</b>	<b>(25,853)</b>	<b>(1,378)</b>	<b>2,400</b>	<b>-</b>		
<b>Interest rate sensitivity gap</b>	<b>146,332</b>	<b>26,085</b>	<b>431,272</b>	<b>236,818</b>	<b>205,641</b>	<b>149,037</b>	<b>1,195,185</b>		

<sup>1</sup> 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 21 and 22). The fixed rate is determined every January. As at 31 December 2010, such placements amounted to HK\$668,792 million (2009: HK\$545,611 million).

## Exchange Fund – Notes to the Financial Statements (continued)

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

### (b) Currency risk

The currency exposure of the Group is summarised below:

	Group			
	2010		2009	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	(restated) Assets (in HK\$ billion)	(restated) Liabilities (in HK\$ billion)
Hong Kong dollar	238.0	1,533.4	187.5	1,418.5
US dollar <sup>1</sup>	1,879.5	261.3	1,772.9	226.0
	2,117.5	1,794.7	1,960.4	1,644.5
Others <sup>2</sup>	283.0	5.8	247.9	4.5
<b>TOTAL</b>	<b>2,400.5</b>	<b>1,800.5</b>	2,208.3	1,649.0

	Fund			
	2010		2009	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	(restated) Assets (in HK\$ billion)	(restated) Liabilities (in HK\$ billion)
Hong Kong dollar	217.0	1,496.1	150.2	1,376.0
US dollar <sup>1</sup>	1,853.0	253.1	1,754.0	217.4
	2,070.0	1,749.2	1,904.2	1,593.4
Others <sup>2</sup>	275.0	4.3	245.2	2.5
<b>TOTAL</b>	<b>2,345.0</b>	<b>1,753.5</b>	2,149.4	1,595.9

<sup>1</sup> Assets and liabilities denominated in Australian dollar, Canadian dollar and Singapore dollar which were grouped under "US dollar and other currencies" in 2009 have been re-categorised under "Others" in 2010.

<sup>2</sup> These included assets and liabilities denominated mainly in Australian dollar, Canadian dollar, Danish krone, euro, Norwegian krone, Singapore dollar, sterling, Swedish krona, Swiss franc and yen.

### (c) Equity price risk

As at 31 December 2010 and 2009, the majority of equity investments were reported as "financial assets designated at fair value" as shown in note 9.

# Exchange Fund – Notes to the Financial Statements (continued)

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

## 34.4.4 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	
	2010	2009
<b>VaR</b>		
At 31 December	<b>34,854</b>	30,324
During the year		
Average	<b>30,996</b>	41,435
Maximum	<b>37,573</b>	64,131
Minimum	<b>26,203</b>	30,324

## 34.5 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.

### 34.5.1 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 (continued)

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

## 34.5.2 Exposure to liquidity risk

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, are shown below.

	Group – 2010						Total
	Remaining maturity						
	1 month or less	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	
<b>Non-derivative cash outflows</b>							
Certificates of Indebtedness	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	8,899	-	-	-	-	-	8,899
Balance of the banking system	148,702	-	-	-	-	-	148,702
Placements by banks and other financial institutions	-	-	23,187	-	-	-	23,187
Placements by Fiscal Reserves	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	29,210	-	-	35,000	12,550	-	76,760
Exchange Fund Bills and Notes issued	133,243	318,914	148,486	44,047	9,215	4,605	658,510
Other debt securities issued	3,048	4,277	10,978	18,139	3,987	1,424	41,853
Mortgage-backed securities issued	28	49	1,297	166	-	-	1,540
Other liabilities	26,783	239	12	-	-	-	27,034
Loan commitments and other credit related commitments	144,691	-	-	-	-	-	144,691
<b>TOTAL</b>	<b>1,312,825</b>	<b>323,479</b>	<b>183,960</b>	<b>97,352</b>	<b>25,752</b>	<b>6,029</b>	<b>1,949,397</b>
<b>Derivative cash (inflows)/outflows</b>							
Derivative financial instruments settled:							
- on net basis	292	(3)	(62)	(26)	335	101	637
- on gross basis							
Total outflows	37,684	31,766	28,388	9,668	-	-	107,506
Total inflows	(36,707)	(31,205)	(28,000)	(9,669)	-	-	(105,581)
<b>TOTAL</b>	<b>1,269</b>	<b>558</b>	<b>326</b>	<b>(27)</b>	<b>335</b>	<b>101</b>	<b>2,562</b>

## Exchange Fund – Notes to the Financial Statements (continued)

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

	Group – 2009						Total
	Remaining maturity						
	1 month or less	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	
<b>Non-derivative cash outflows</b>							
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
<b>TOTAL</b>	<b>1,207,889</b>	<b>272,613</b>	<b>132,358</b>	<b>76,379</b>	<b>48,429</b>	<b>6,240</b>	<b>1,743,908</b>
<b>Derivative cash (inflows)/outflows</b>							
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)
<b>TOTAL</b>	<b>593</b>	<b>33</b>	<b>129</b>	<b>71</b>	<b>182</b>	<b>54</b>	<b>1,062</b>

# Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2010						Total
	Remaining maturity						
	1 month or less	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	
<b>Non-derivative cash outflows</b>							
Certificates of Indebtedness	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	8,899	-	-	-	-	-	8,899
Balance of the banking system	148,702	-	-	-	-	-	148,702
Placements by banks and other financial institutions	-	-	23,187	-	-	-	23,187
Placements by Fiscal Reserves	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	29,210	-	-	35,000	12,550	-	76,760
Exchange Fund Bills and Notes issued	133,743	318,914	148,486	44,047	9,215	4,605	659,010
Other liabilities	20,484	239	12	-	-	-	20,735
Loan commitments and other credit related commitments	151,418	-	-	-	-	-	151,418
<b>TOTAL</b>	<b>1,310,677</b>	<b>319,153</b>	<b>171,685</b>	<b>79,047</b>	<b>21,765</b>	<b>4,605</b>	<b>1,906,932</b>
<b>Derivative cash (inflows)/outflows</b>							
Derivative financial instruments settled:							
- on net basis	294	(13)	(65)	(45)	335	101	607
- on gross basis							
Total outflows	35,961	29,533	23,593	-	-	-	89,087
Total inflows	(34,987)	(28,970)	(23,187)	-	-	-	(87,144)
<b>TOTAL</b>	<b>1,268</b>	<b>550</b>	<b>341</b>	<b>(45)</b>	<b>335</b>	<b>101</b>	<b>2,550</b>

# Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2009						Total
	Remaining maturity						
	1 month or less	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	
<b>Non-derivative cash outflows</b>							
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
<b>TOTAL</b>	<b>1,230,830</b>	<b>268,868</b>	<b>124,046</b>	<b>46,712</b>	<b>43,825</b>	<b>3,344</b>	<b>1,717,625</b>
<b>Derivative cash (inflows)/outflows</b>							
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)
<b>TOTAL</b>	<b>575</b>	<b>33</b>	<b>47</b>	<b>34</b>	<b>169</b>	<b>54</b>	<b>912</b>

## 34.6 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% to 30% of the value of properties financed under mortgage loans with loan-to-value ratio below 90% at origination. The Group reinsures the exposure with approved reinsurers. As at 31 December 2010, the total risk-in-force was HK\$17.6 billion (2009: HK\$14.9 billion), of which HK\$15.2 billion (2009: HK\$11.6 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 (continued)

(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.

### 34.7 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 and the results of past audits.

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.



## Exchange Fund – Notes to the Financial Statements (continued)

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

### 35 FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

The fair values of financial instruments traded in active markets are 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:

	Note	Group			
		Carrying value		Fair value	
		2010	2009	2010	2009
<b>Financial assets</b>					
Held-to-maturity securities	11	<b>8,108</b>	5,883	<b>8,259</b>	6,001
<b>Financial liabilities</b>					
Other debt securities issued, not designated at fair value	24	<b>37,163</b>	41,613	<b>37,165</b>	41,619
Mortgage-backed securities issued, not designated at fair value	25	<b>1,530</b>	2,021	<b>1,525</b>	2,011

All other financial instruments of the Group and the Fund are stated at fair value or carried at amounts not materially different from their fair values as at 31 December 2010 and 2009.

## Exchange Fund – Notes to the Financial Statements (continued)

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

- (b) The carrying value of financial instruments measured at fair value at the balance sheet date across the three levels of the fair value hierarchy is shown below:

	Group – 2010			Total
	Level 1	Level 2	Level 3	
<b>Assets</b>				
Derivative financial instruments	41	3,258	–	3,299
Financial assets designated at fair value	1,719,068	369,122	20,774	2,108,964
Available-for-sale securities	1,469	1,435	8,929	11,833
	<b>1,720,578</b>	<b>373,815</b>	<b>29,703</b>	<b>2,124,096</b>
<b>Liabilities</b>				
Derivative financial instruments	293	2,180	–	2,473
Exchange Fund Bills and Notes issued	–	653,721	–	653,721
Other debt securities issued, designated at fair value	–	1,937	–	1,937
	<b>293</b>	<b>657,838</b>	<b>–</b>	<b>658,131</b>

	Group – 2009			Total
	Level 1	Level 2	Level 3	
<b>Assets</b>				
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
	<b>1,730,576</b>	<b>246,802</b>	<b>30,836</b>	<b>2,008,214</b>
<b>Liabilities</b>				
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
	<b>167</b>	<b>540,139</b>	<b>–</b>	<b>540,306</b>

## Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2010			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Derivative financial instruments	41	1,861	–	1,902
Financial assets designated at fair value	1,719,068	365,783	19,711	2,104,562
	1,719,109	367,644	19,711	2,106,464
<b>Liabilities</b>				
Derivative financial instruments	293	2,136	–	2,429
Exchange Fund Bills and Notes issued	–	654,221	–	654,221
	293	656,357	–	656,650

	Fund – 2009			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
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
<b>Liabilities</b>				
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 (unadjusted) 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 (continued)

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

An analysis 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, is shown below:

	Group			
	Designated at fair value		Available-for-sale	
	2010	2009	2010	2009
At 1 January	<b>27,264</b>	18,704	<b>3,572</b>	–
Net gains recognised in the income and expenditure account	<b>866</b>	3,583	–	–
Net gains recognised in other comprehensive income	–	–	<b>1,103</b>	743
Purchases	<b>7,525</b>	13,337	<b>4,452</b>	2,848
Sales	<b>(5,269)</b>	(7,460)	<b>(198)</b>	(19)
Transfers into Level 3	<b>7,163</b>	–	–	–
Transfers out of Level 3	<b>(16,775)</b>	(900)	–	–
At 31 December	<b>20,774</b>	27,264	<b>8,929</b>	3,572
Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date	<b>1,300</b>	3,123	–	–

  

	Fund			
	Designated at fair value		Available-for-sale	
	2010	2009	2010	2009
At 1 January	<b>27,264</b>	18,704	–	–
Net gains recognised in the income and expenditure account	<b>869</b>	3,583	–	–
Purchases	<b>6,459</b>	13,337	–	–
Sales	<b>(5,269)</b>	(7,460)	–	–
Transfers into Level 3	<b>7,163</b>	–	–	–
Transfers out of Level 3	<b>(16,775)</b>	(900)	–	–
At 31 December	<b>19,711</b>	27,264	–	–
Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date	<b>1,303</b>	3,123	–	–

# Exchange Fund – Notes to the Financial Statements (continued)

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

During the year, certain financial instruments were transferred between Level 2 and Level 3, reflecting changes in transparency of observable market data for these instruments.

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\$2,077 million (2009: HK\$2,726 million) and in other comprehensive income of HK\$893 million (2009: HK\$357 million).

## 36 COMPARATIVE FIGURES

As a result of adopting Amendment to HKAS 17, certain comparative figures have been reclassified and restated to conform with changes in presentations in the current year and to show separately comparative amount in respect of item disclosed (note 3.3).

## 37 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2010

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 2010 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 revised disclosures in future financial statements:

	Effective for accounting periods beginning on or after
Amendments to HKFRS 7, Financial Instruments: Disclosures	
– Disclosures - Transfers of Financial Assets	1 July 2011
HKFRS 9, Financial Instruments	1 January 2013
Amendments to HKAS 12, Income Taxes	
– Deferred Tax: Recovery of Underlying Assets	1 January 2012
HKAS 24 (Revised), Related Party Disclosures	1 January 2011
Amendment to HKAS 32, Financial Instruments: Presentation	
– Classification of Rights Issues	1 February 2010

## 38 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 29 March 2011.