

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 2011, 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 2011, 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

2 April 2012

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

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2011

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2011	2010	2011	2010
INCOME					
Interest income		21,114	20,524	19,718	19,231
Dividend income		9,507	8,433	9,745	8,614
Net realised and revaluation gains		3,683	55,871	3,063	55,547
Net exchange loss		(8,860)	(3,026)	(9,080)	(3,074)
Investment income	4(a)	25,444	81,802	23,446	80,318
Bank licence fees		136	134	136	134
Other income		781	626	93	74
TOTAL INCOME		26,361	82,562	23,675	80,526
EXPENDITURE					
Interest expense on placements by Fiscal Reserves, HKSAR government funds and statutory bodies	4(b)	(42,589)	(37,629)	(42,589)	(37,629)
Other interest expense	4(c)	(2,043)	(2,204)	(1,779)	(2,034)
Operating expenses	4(d)	(2,963)	(2,781)	(2,659)	(2,529)
Note and coin expenses	4(e)	(237)	(288)	(237)	(288)
Write back of impairment losses on loans/ (Impairment losses on loans)		(3)	17	-	-
TOTAL EXPENDITURE		(47,835)	(42,885)	(47,264)	(42,480)
SURPLUS/(DEFICIT) BEFORE SHARE OF PROFIT/(LOSS) OF ASSOCIATE AND JOINT VENTURES					
		(21,474)	39,677	(23,589)	38,046
Share of profit/(loss) of associate and joint ventures, net of tax		89	(154)	-	-
SURPLUS/(DEFICIT) BEFORE TAXATION		(21,385)	39,523	(23,589)	38,046
Income tax		(185)	(178)	-	-
SURPLUS/(DEFICIT) FOR THE YEAR		(21,570)	39,345	(23,589)	38,046
ATTRIBUTABLE TO:					
Owner of the Fund		(21,585)	39,333	(23,589)	38,046
Non-controlling interests		15	12	-	-
		(21,570)	39,345	(23,589)	38,046

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 2011

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2011	2010	2011	2010
SURPLUS/(DEFICIT) FOR THE YEAR		(21,570)	39,345	(23,589)	38,046
OTHER COMPREHENSIVE INCOME					
Available-for-sale securities					
fair value changes taken to equity	29	(284)	1,248	-	-
fair value changes on disposal transferred to income and expenditure account	29	(51)	(40)	-	-
tax effect	29	(10)	(17)	-	-
Cash flow hedges					
fair value changes taken to equity	29	3	26	-	-
fair value changes transferred to income and expenditure account	29	10	-	-	-
tax effect	29	(2)	(4)	-	-
Exchange difference on translation of financial statements of overseas subsidiaries and joint ventures		2	48	-	-
OTHER COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR, NET OF TAX		(332)	1,261	-	-
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR		(21,902)	40,606	(23,589)	38,046
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR ATTRIBUTABLE TO:					
Owner of the Fund		(21,918)	40,594	(23,589)	38,046
Non-controlling interests		16	12	-	-
		(21,902)	40,606	(23,589)	38,046

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

Exchange Fund – Balance Sheet

as at 31 December 2011

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2011	2010	2011	2010
ASSETS					
Cash and money at call	6	60,564	49,579	60,138	48,911
Placements with banks and other financial institutions	7	171,805	155,455	161,529	149,478
Derivative financial instruments	8(a)	4,355	3,299	2,796	1,902
Financial assets designated at fair value	9	2,212,397	2,108,964	2,203,217	2,104,562
Available-for-sale securities	10	23,464	12,326	493	493
Held-to-maturity securities	11	8,365	8,108	–	–
Loan portfolio	12	33,136	35,259	–	–
Gold	13	817	732	817	732
Other assets	14	23,522	19,772	22,526	18,770
Investments in subsidiaries	15	–	–	33,278	16,828
Interests in associate and joint ventures	16	3,264	3,461	–	–
Investment properties	17	3,126	–	–	–
Property, plant and equipment	18(a)	3,423	3,501	3,238	3,308
TOTAL ASSETS		2,548,238	2,400,456	2,488,032	2,344,984
LIABILITIES AND EQUITY					
Certificates of Indebtedness	19	258,702	225,939	258,702	225,939
Government-issued currency notes and coins in circulation	19	9,888	8,899	9,888	8,899
Balance of the banking system	20	148,684	148,702	148,684	148,702
Derivative financial instruments	8(a)	935	2,473	672	2,429
Placements by banks and other financial institutions	21	24,547	23,187	24,547	23,187
Placements by Fiscal Reserves	22	663,507	592,282	663,507	592,282
Placements by Hong Kong Special Administrative Region government funds and statutory bodies	23	126,249	76,760	126,249	76,760
Exchange Fund Bills and Notes issued	24	655,750	653,721	655,750	654,221
Bank loans	25	1,876	–	–	–
Mortgage-backed securities issued	26	367	1,530	–	–
Other debt securities issued	27	41,058	39,100	–	–
Other liabilities	28	38,639	27,919	32,119	21,062
Total liabilities		1,970,202	1,800,512	1,920,118	1,753,481
Accumulated surplus	29	575,968	597,553	567,914	591,503
Other reserves	29	1,786	2,119	–	–
Total equity attributable to owner of the Fund		577,754	599,672	567,914	591,503
Non-controlling interests	29	282	272	–	–
Total equity		578,036	599,944	567,914	591,503
TOTAL LIABILITIES AND EQUITY		2,548,238	2,400,456	2,488,032	2,344,984

Norman T.L. Chan

Monetary Authority
2 April 2012

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 2011

(Expressed in millions of Hong Kong dollars)	Note	Attributable to owner of the Fund					Non-controlling interests	Total
		Accumulated surplus	Other reserves		Total attributable to owner of the Fund			
			Revaluation reserve	Translation reserve				
Group								
At 1 January 2010		558,220	865	(7)	559,078	204	559,282	
Surplus for the year	29	39,333	-	-	39,333	12	39,345	
Other comprehensive income for the year	29	-	1,213	48	1,261	-	1,261	
Total comprehensive income for the year		39,333	1,213	48	40,594	12	40,606	
Capital injection by non-controlling interests	29	-	-	-	-	67	67	
Dividends paid to non-controlling interests	29	-	-	-	-	(11)	(11)	
At 31 December 2010		597,553	2,078	41	599,672	272	599,944	
At 1 January 2011		597,553	2,078	41	599,672	272	599,944	
Surplus/(Deficit) for the year	29	(21,585)	-	-	(21,585)	15	(21,570)	
Other comprehensive income/(loss) for the year	29	-	(334)	1	(333)	1	(332)	
Total comprehensive income/(loss) for the year		(21,585)	(334)	1	(21,918)	16	(21,902)	
Capital injection by non-controlling interests	29	-	-	-	-	4	4	
Dividends paid to non-controlling interests	29	-	-	-	-	(10)	(10)	
At 31 December 2011		575,968	1,744	42	577,754	282	578,036	
Fund								
At 1 January 2010		553,457	-	-	553,457	-	553,457	
Surplus and total comprehensive income for the year	29	38,046	-	-	38,046	-	38,046	
At 31 December 2010		591,503	-	-	591,503	-	591,503	
At 1 January 2011		591,503	-	-	591,503	-	591,503	
Deficit and total comprehensive loss for the year	29	(23,589)	-	-	(23,589)	-	(23,589)	
At 31 December 2011		567,914	-	-	567,914	-	567,914	

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 2011

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2011	2010	2011	2010
Cash flows from operating activities					
Surplus/(Deficit) before share of profit/(loss) of associate and joint ventures		(21,474)	39,677	(23,589)	38,046
Adjustments for:					
Interest income	4(a)	(21,114)	(20,524)	(19,718)	(19,231)
Dividend income	4(a)	(9,507)	(8,433)	(9,745)	(8,614)
Change in fair value of investment properties	4(a)	134	–	–	–
Net gains on disposal of available-for-sale securities	4(a)	(719)	(167)	–	–
Interest expense	4(b) & 4(c)	44,632	39,833	44,368	39,663
Depreciation	4(d)	151	148	117	110
Elimination of exchange differences and other non-cash items		(422)	(556)	(542)	(556)
Interest received		21,582	20,636	19,945	19,396
Interest paid		(44,857)	(39,798)	(44,421)	(39,729)
Dividends received		9,317	8,427	9,193	8,095
Income tax paid		(188)	(174)	–	–
		(22,465)	39,069	(24,392)	37,180
Change in fair value of derivatives and other debt securities issued		(2,525)	3,959	(2,648)	3,927
Change in carrying amount of:					
– placements with banks and other financial institutions		1,900	(361)	778	753
– financial assets designated at fair value		(90,337)	(183,361)	(85,560)	(178,959)
– loan portfolio		2,117	8,542	–	–
– gold		(85)	(160)	(85)	(160)
– other assets		(4,016)	(4,814)	(3,794)	(4,928)
– Certificates of Indebtedness, government-issued currency notes and coins in circulation		33,752	27,405	33,752	27,405
– balance of the banking system		(18)	(115,865)	(18)	(115,865)
– placements by banks and other financial institutions		1,360	(5,124)	1,360	(5,124)
– placements by Fiscal Reserves		71,225	88,159	71,225	88,159
– placements by Hong Kong Special Administrative Region government funds and statutory bodies		49,489	34,924	49,489	34,924
– Exchange Fund Bills and Notes issued		2,029	117,292	1,529	117,792
– other liabilities		11,007	9,144	11,108	8,739
Net cash from operating activities		53,433	18,809	52,744	13,843

Exchange Fund – Statement of Cash Flows (continued)

for the year ended 31 December 2011

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2011	2010	2011	2010
Cash flows from investing activities					
Loans to subsidiaries		-	-	(16,450)	(11,881)
(Increase)/Decrease in investment in joint ventures		303	(3,443)	-	-
Proceeds from sale or redemption of available-for-sale securities		3,050	4,944	-	-
Purchase of available-for-sale securities		(13,805)	(8,215)	-	-
Proceeds from redemption of held-to-maturity securities		1,520	2,152	-	-
Purchase of held-to-maturity securities		(1,775)	(4,375)	-	-
Proceeds from disposal of property, plant and equipment		-	3	-	-
Purchase of investment properties		(3,421)	-	-	-
Purchase of property, plant and equipment		(73)	(57)	(47)	(44)
Dividends received from subsidiaries		-	-	362	513
Net cash used in investing activities		(14,201)	(8,991)	(16,135)	(11,412)
Cash flows from financing activities					
Bank loans raised		1,876	-	-	-
Proceeds from issue of other debt securities		28,526	8,193	-	-
Redemption of mortgage-backed securities issued		(1,139)	(470)	-	-
Redemption of other debt securities issued		(26,719)	(13,831)	-	-
Capital injection by non-controlling interests		4	67	-	-
Dividends paid to non-controlling interests		(10)	(11)	-	-
Net cash from/(used in) financing activities		2,538	(6,052)	-	-
Net increase in cash and cash equivalents		41,770	3,766	36,609	2,431
Cash and cash equivalents at 1 January		212,464	208,120	207,236	204,249
Effect of foreign exchange rate changes		557	578	542	556
Cash and cash equivalents at 31 December	30	254,791	212,464	244,387	207,236

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 31.

2 SIGNIFICANT ACCOUNTING POLICIES

2.1 Statement of compliance

These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (HKFRSs), which is a collective term that includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards (HKASs) and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (HKICPA), and accounting principles generally accepted in Hong Kong. A summary of the significant accounting policies adopted by the 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 first effective or available for early adoption for the current accounting period. Note 3 provides information on the changes, if any, 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);
- gold (note 2.10); and
- investment properties (note 2.11).

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

2.3 Subsidiaries and non-controlling interests

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.

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

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

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.

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 2.13).

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. When the Group's share of losses exceeds its interest in the associate or the joint ventures, the Group's interest is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate or the joint ventures. For this purpose, the Group's interest is the carrying amount of the investment under the equity method together with the Group's long-term interests that in substance form part of the Group's net investment in the associate or the joint ventures.

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 2.13).

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.

An analysis of the Group's financial assets and financial liabilities by category 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, in the case of a financial asset or financial liability not at fair value through the income and expenditure account, transaction costs 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.

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).

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.

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).

Exchange Fund – Notes to the Financial Statements (continued)

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

2.5.2.5 Available-for-sale securities

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

Available-for-sale securities are carried at fair value. Unrealised gains and losses arising from changes in the fair value are recognised 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, bank loans 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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

2.5.3 Fair value measurement principles

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

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

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

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). The embedded derivative is measured at fair value with change in fair value recognised in the income and expenditure account.

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. Objective evidence that a financial asset is impaired includes observable data that comes to the attention of the Group about one or more of the following loss events which has an impact on the future cash flows on the financial asset that can be estimated reliably:

- significant financial difficulties of the issuer or borrower;
- a breach of contract such as default or delinquency in interest or principal payments;
- it becoming probable that the issuer or borrower will enter bankruptcy or other financial reorganisation;
- significant changes in the technological, market, economic or legal environment that have an adverse effect on the issuer or borrower;
- disappearance of an active market for that financial asset; and
- a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. For exposures which are not individually significant, the Group will assess impairment either individually or collectively. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes that asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Financial assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If any such evidence exists, the carrying amount is reduced to the estimated recoverable amount and the impairment loss is determined and recognised as described below.

For loans and receivables and held-to-maturity securities, an impairment loss is 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. The carrying amount of the asset is reduced through the use of an allowance account and the impairment loss is recognised in the income and expenditure account.

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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 Investment properties

Properties that are held for long-term rental yields or for capital appreciation or both, and that are not occupied by the Group, are classified as investment properties.

Investment properties are recognised initially at cost, including related transaction costs. After initial recognition, investment properties are measured at fair value assessed by investment managers or independent professional valuers, when appropriate, on the basis of open market value. If this information is not available, alternative valuation methods are used such as recent prices on less active markets or discounted cash flow projections.

Any gain or loss arising from change in fair value or disposal of an investment property is recognised directly in the income and expenditure account. Rental income from investment properties is recognised in the income and expenditure account in equal instalments over the periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the use of the leased asset.

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

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

2.12 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 2.13):

- 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.

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.

2.13 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

2.14 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.

2.15 Revenue and expenditure recognition

2.15.1 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 22 and 23). Interest on these placements is recognised 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.

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.

2.15.2 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.

2.15.3 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 the mortgage insurance business of the HKMC. Rental income is recognised on a straight-line basis over the lease term. The net premiums are recognised on a time-apportioned basis during the time the insurance coverage is effective. 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.)

2.15.4 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.

2.15.5 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.

2.15.6 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.

2.16 Foreign currency translation

The financial statements are presented in Hong Kong dollars, which is the Group's and 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.)

2.17 Related parties

For the purposes of these financial statements, a person or an entity is considered to be related to the Group if:

- (a) the person, or a close member of that person's family:
 - (i) has control or joint control over the Group;
 - (ii) has significant influence over the Group; or
 - (iii) is a member of the key management personnel of the Group.
- (b) any of the following conditions applies to the entity:
 - (i) the entity and the Group are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others);
 - (ii) the entity is an associate or joint venture of the Group (or an associate or joint venture of a member of a group of which the Group is a member);
 - (iii) the entity and the Group are joint ventures of the same third party;
 - (iv) the entity is a joint venture of another entity and the Group is an associate of that entity;
 - (v) the entity is a post-employment benefit plan for the benefit of employees of either the Group or an entity related to the Group;
 - (vi) the entity is controlled or jointly controlled by a person identified in (a); or
 - (vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

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

Exchange Fund – Notes to the Financial Statements (continued)

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

2.18 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 Hong Kong Note Printing Limited.

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

3 CHANGES IN ACCOUNTING POLICIES

The HKICPA has issued certain new and revised HKFRSs that are first effective or available for early adoption 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.

HKAS 24 (Revised), Related Party Disclosures clarifies the definition of a related party. It also provides a partial exemption from the disclosure requirements for government-related entities to disclose details of all transactions with the government and other government-related entities. The Group has not applied the exemption from the disclosure requirements for government-related entities.

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (note 38).

Exchange Fund – Notes to the Financial Statements (continued)

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

4 INCOME AND EXPENDITURE

(a) Investment income

	Group		Fund	
	2011	2010	2011	2010
Interest income:				
– from derivative financial instruments	440	395	440	395
– from financial assets designated at fair value	19,091	18,581	18,768	18,454
– from other financial assets	1,583	1,548	510	382
	21,114	20,524	19,718	19,231
Dividend income:				
– from financial assets designated at fair value	9,367	8,067	9,367	8,067
– from other financial assets	140	366	16	35
– from subsidiaries	-	-	362	512
	9,507	8,433	9,745	8,614
Income from investment properties:				
– rental income	134	-	-	-
– change in fair value on revaluation ¹	(134)	-	-	-
	-	-	-	-
Net realised and revaluation gains/(losses):				
– on derivative financial instruments	(544)	777	(487)	578
– on financial assets and financial liabilities designated at fair value	3,508	54,927	3,550	54,969
– on disposal of available-for-sale securities	719	167	-	-
	3,683	55,871	3,063	55,547
Net exchange loss	(8,860)	(3,026)	(9,080)	(3,074)
TOTAL	25,444	81,802	23,446	80,318

¹ The change in fair value of investment properties is arrived at by comparing the valuation at year end with acquisition cost which includes the purchase consideration of the properties and related transaction costs.

Exchange Fund – Notes to the Financial Statements (continued)

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

(b) Interest expense on placements by Fiscal Reserves, HKSAR government funds and statutory bodies

	Group		Fund	
	2011	2010	2011	2010
Interest on placements by Fiscal Reserves:				
– at a fixed rate determined annually ²	36,958	33,765	36,958	33,765
– at market-based rates	1	1	1	1
Interest on placements by HKSAR government funds and statutory bodies:				
– at a fixed rate determined annually ²	5,629	3,863	5,629	3,863
– at market-based rates	1	–	1	–
TOTAL	42,589	37,629	42,589	37,629

² This rate has been fixed at 6.0% per annum for 2011 (2010: 6.3% – notes 22 and 23).

(c) Other interest expense

	Group		Fund	
	2011	2010	2011	2010
Interest on Exchange Fund Bills and Notes issued	1,667	1,814	1,667	1,815
Interest expense on derivative financial instruments	47	194	21	194
Interest expense on other debt securities issued designated at fair value and trading liabilities	29	170	26	2
Interest expense on other financial liabilities	300	26	65	23
TOTAL	2,043	2,204	1,779	2,034

Exchange Fund – Notes to the Financial Statements (continued)

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

(d) Operating expenses

	Group		Fund	
	2011	2010	2011	2010
Staff costs				
Salaries and other staff costs	917	843	751	697
Retirement benefit costs	67	61	59	53
Premises and equipment expenses				
Depreciation	151	148	117	110
Rental expenses under operating leases	44	44	42	42
Other premises expenses	53	53	45	44
General operating costs				
Maintenance of office and computer equipment	58	45	52	38
Financial information and communication services	46	41	40	36
External relations	38	25	29	23
Service fees for financial infrastructure	51	27	51	27
Professional and other services	48	54	28	35
Training	8	6	7	6
Others	22	23	25	22
Investment management and custodian fees				
Management and custodian fees	825	789	795	777
Transaction costs	202	178	186	175
Withholding tax	399	427	399	427
Others	34	17	33	17
TOTAL	2,963	2,781	2,659	2,529

The aggregate emoluments of senior staff (Executive Directors and above) of the Group were as follows:

	Group	
	2011	2010
Fixed pay	60.9	57.2
Variable pay	15.0	10.3
Other benefits	6.9	5.7
	82.8	73.2

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

Exchange Fund – Notes to the Financial Statements (continued)

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

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

HK\$	Group	
	2011	2010
500,000 or below	-	1
1,500,001 to 2,000,000	-	1
2,000,001 to 2,500,000	-	3
3,000,001 to 3,500,000	-	2
3,500,001 to 4,000,000	5	1
4,000,001 to 4,500,000	2	4
4,500,001 to 5,000,000	3	1
5,000,001 to 5,500,000	1	1
5,500,001 to 6,000,000	1	1
6,500,001 to 7,000,000	1	2
7,000,001 to 7,500,000	2	-
7,500,001 to 8,000,000	-	1
9,000,001 to 9,500,000	1	-
	16	18

(e) 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	Group – 2011						
		Total	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	Other financial liabilities
Cash and money at call	6	60,564	-	-	60,564	-	-	-
Placements with banks and other financial institutions	7	171,805	-	-	171,805	-	-	-
Derivative financial instruments	8(a)	4,355	4,355	-	-	-	-	-
Financial assets designated at fair value	9	2,212,397	-	2,212,397	-	-	-	-
Available-for-sale securities	10	23,464	-	-	-	-	23,464	-
Held-to-maturity securities	11	8,365	-	-	-	8,365	-	-
Loan portfolio	12	33,136	-	-	33,136	-	-	-
Others		23,395	-	-	23,395	-	-	-
FINANCIAL ASSETS		2,537,481	4,355	2,212,397	288,900	8,365	23,464	-
Certificates of Indebtedness	19	258,702	-	-	-	-	-	258,702
Government-issued currency notes and coins in circulation	19	9,888	-	-	-	-	-	9,888
Balance of the banking system	20	148,684	-	-	-	-	-	148,684
Derivative financial instruments	8(a)	935	935	-	-	-	-	-
Placements by banks and other financial institutions	21	24,547	-	-	-	-	-	24,547
Placements by Fiscal Reserves	22	663,507	-	-	-	-	-	663,507
Placements by HKSAR government funds and statutory bodies	23	126,249	-	-	-	-	-	126,249
Exchange Fund Bills and Notes issued	24	655,750	-	655,750	-	-	-	-
Bank loans	25	1,876	-	-	-	-	-	1,876
Mortgage-backed securities issued	26	367	-	-	-	-	-	367
Other debt securities issued	27	41,058	-	892	-	-	-	40,166
Others		38,250	-	-	-	-	-	38,250
FINANCIAL LIABILITIES		1,969,813	935	656,642	-	-	-	1,312,236

Exchange Fund – Notes to the Financial Statements (continued)

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

	Note	Total	Group – 2010					
			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	Other financial liabilities
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	-	-	-
Others		19,683	-	-	19,683	-	-	-
FINANCIAL ASSETS		2,392,673	3,299	2,108,964	259,976	8,108	12,326	-
Certificates of Indebtedness	19	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	19	8,899	-	-	-	-	-	8,899
Balance of the banking system	20	148,702	-	-	-	-	-	148,702
Derivative financial instruments	8(a)	2,473	2,473	-	-	-	-	-
Placements by banks and other financial institutions	21	23,187	-	-	-	-	-	23,187
Placements by Fiscal Reserves	22	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	23	76,760	-	-	-	-	-	76,760
Exchange Fund Bills and Notes issued	24	653,721	-	653,721	-	-	-	-
Mortgage-backed securities issued	26	1,530	-	-	-	-	-	1,530
Other debt securities issued	27	39,100	-	1,937	-	-	-	37,163
Others		27,618	-	-	-	-	-	27,618
FINANCIAL LIABILITIES		1,800,211	2,473	655,658	-	-	-	1,142,080

Exchange Fund – Notes to the Financial Statements (continued)

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

	Note	Fund – 2011						
		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	60,138	-	-	60,138	-	-	-
Placements with banks and other financial institutions	7	161,529	-	-	161,529	-	-	-
Derivative financial instruments	8(a)	2,796	2,796	-	-	-	-	-
Financial assets designated at fair value	9	2,203,217	-	2,203,217	-	-	-	-
Available-for-sale securities	10	493	-	-	-	-	493	-
Others		22,507	-	-	22,507	-	-	-
FINANCIAL ASSETS		2,450,680	2,796	2,203,217	244,174	-	493	-
Certificates of Indebtedness	19	258,702	-	-	-	-	-	258,702
Government-issued currency notes and coins in circulation	19	9,888	-	-	-	-	-	9,888
Balance of the banking system	20	148,684	-	-	-	-	-	148,684
Derivative financial instruments	8(a)	672	672	-	-	-	-	-
Placements by banks and other financial institutions	21	24,547	-	-	-	-	-	24,547
Placements by Fiscal Reserves	22	663,507	-	-	-	-	-	663,507
Placements by HKSAR government funds and statutory bodies	23	126,249	-	-	-	-	-	126,249
Exchange Fund Bills and Notes issued	24	655,750	-	655,750	-	-	-	-
Others		32,035	-	-	-	-	-	32,035
FINANCIAL LIABILITIES		1,920,034	672	655,750	-	-	-	1,263,612

Exchange Fund – Notes to the Financial Statements (continued)

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

				Fund – 2010				
	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	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	-
Others		18,758	-	-	18,758	-	-	-
FINANCIAL ASSETS		2,324,104	1,902	2,104,562	217,147	-	493	-
Certificates of Indebtedness	19	225,939	-	-	-	-	-	225,939
Government-issued currency notes and coins in circulation	19	8,899	-	-	-	-	-	8,899
Balance of the banking system	20	148,702	-	-	-	-	-	148,702
Derivative financial instruments	8(a)	2,429	2,429	-	-	-	-	-
Placements by banks and other financial institutions	21	23,187	-	-	-	-	-	23,187
Placements by Fiscal Reserves	22	592,282	-	-	-	-	-	592,282
Placements by HKSAR government funds and statutory bodies	23	76,760	-	-	-	-	-	76,760
Exchange Fund Bills and Notes issued	24	654,221	-	654,221	-	-	-	-
Others		20,986	-	-	-	-	-	20,986
FINANCIAL LIABILITIES		1,753,405	2,429	654,221	-	-	-	1,096,755

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	
	2011	2010	2011	2010
At amortised cost				
Balance with central banks	25,498	24,212	25,498	24,212
Balance with banks	35,066	25,367	34,640	24,699
TOTAL	60,564	49,579	60,138	48,911

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2011	2010	2011	2010
At amortised cost				
Placements in respect of reverse repurchase agreements:				
– with central banks	38,863	38,897	38,863	38,897
– with banks and other financial institutions	4,849	5,018	4,849	5,018
Other placements with banks	128,093	111,540	117,817	105,563
TOTAL	171,805	155,455	161,529	149,478

8 DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments refer to financial contracts whose value depends on the value of one or more underlying assets or indices with settlement at a future date.

The Group uses derivative financial instruments to manage its exposures to market risk and to facilitate the implementation of investment strategies. The principal derivative financial instruments used are interest rate and currency swap contracts, forward foreign exchange contracts, and currency and bond options contracts, which are primarily over-the-counter derivatives, as well as exchange-traded futures contracts.

Market risk arising from derivative financial instruments is included as part of the overall market risk exposure. The credit risk arising from these transactions is marked against the overall credit exposure to individual counterparties. The financial risk management approaches are outlined in note 36.

Exchange Fund – Notes to the Financial Statements (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			
	2011		2010		2011		2010	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	1,535	138	647	226	1,472	1	582	199
Interest rate futures contracts	1	-	1	-	1	-	1	-
Equity derivatives								
Equity index swaps	4	-	-	8	4	-	-	8
Stock index futures contracts	529	1	13	279	529	1	13	279
Currency derivatives								
Forward foreign exchange contracts	798	662	1,292	1,937	786	649	1,279	1,929
Bond futures contracts	4	21	27	14	4	21	27	14
	2,871	822	1,980	2,464	2,796	672	1,902	2,429
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	1,251	19	1,029	3	-	-	-	-
Currency derivatives								
Currency swap contracts	233	94	290	2	-	-	-	-
	1,484	113	1,319	5	-	-	-	-
Derivatives designated as hedging instruments in cash flow hedges								
Currency derivatives								
Currency swap contracts	-	-	-	4	-	-	-	-
TOTAL	4,355	935	3,299	2,473	2,796	672	1,902	2,429

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 denominated financial instruments.

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	2011				Total	2010			
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	
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	20,726	1,601	1,011	7,000	11,114	23,650	200	5,809	9,362	8,279
Interest rate futures contracts	3,489	-	843	2,646	-	2,909	638	1,919	352	-
Equity derivatives										
Equity index swaps	508	508	-	-	-	520	-	520	-	-
Stock index futures contracts	37,154	37,154	-	-	-	32,664	32,664	-	-	-
Currency derivatives										
Forward foreign exchange contracts	172,465	156,340	1,344	14,781	-	187,985	159,440	23,187	5,358	-
Bond futures contracts	11,638	11,638	-	-	-	7,818	7,818	-	-	-
	245,980	207,241	3,198	24,427	11,114	255,546	200,760	31,435	15,072	8,279
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	21,418	1,800	3,827	11,767	4,024	27,331	3,868	7,695	11,493	4,275
Currency derivatives										
Currency swap contracts	16,503	927	6,244	9,332	-	7,488	1,091	1,865	4,532	-
	37,921	2,727	10,071	21,099	4,024	34,819	4,959	9,560	16,025	4,275
Derivatives designated as hedging instruments in cash flow hedges										
Currency derivatives										
Currency swap contracts	-	-	-	-	-	2,354	-	-	2,354	-
TOTAL	283,901	209,968	13,269	45,526	15,138	292,719	205,719	40,995	33,451	12,554

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	2011				Total	2010			
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	
Derivatives categorised as trading financial instruments										
Interest rate derivatives										
Interest rate swap contracts	13,400	-	1,000	2,000	10,400	16,206	-	1,000	7,241	7,965
Interest rate futures contracts	3,489	-	843	2,646	-	2,909	638	1,919	352	-
Equity derivatives										
Equity index swaps	508	508	-	-	-	520	-	520	-	-
Stock index futures contracts	37,154	37,154	-	-	-	32,664	32,664	-	-	-
Currency derivatives										
Forward foreign exchange contracts	164,575	153,175	1,344	10,056	-	180,643	157,456	23,187	-	-
Bond futures contracts	11,638	11,638	-	-	-	7,818	7,818	-	-	-
TOTAL	230,764	202,475	3,187	14,702	10,400	240,760	198,576	26,626	7,593	7,965

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Fund	
	2011	2010	2011	2010
At fair value				
Debt securities				
Treasury bills and commercial paper				
Listed outside Hong Kong	18,036	44	18,036	44
Unlisted	714,828	846,014	714,828	846,014
Other debt securities				
Listed outside Hong Kong	561,088	486,515	558,932	485,184
Unlisted	559,623	378,484	552,599	375,413
Total debt securities	1,853,575	1,711,057	1,844,395	1,706,655
Equity securities				
Listed in Hong Kong	120,580	152,572	120,580	152,572
Listed outside Hong Kong	183,717	190,880	183,717	190,880
Unlisted	54,525	54,455	54,525	54,455
Total equity securities	358,822	397,907	358,822	397,907
TOTAL	2,212,397	2,108,964	2,203,217	2,104,562

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	
	2011	2010	2011	2010
Debt securities, at fair value				
Unlisted	294	1,435	-	-
Equity securities				
Listed in Hong Kong, at fair value	2,009	1,469	-	-
Unlisted, at cost	493	493	493	493
	2,502	1,962	493	493
Investment funds, at fair value				
Unlisted	20,668	8,929	-	-
TOTAL	23,464	12,326	493	493

The Group's investment in unlisted equity securities as at 31 December 2011 represents a holding of 4,285 shares (2010: 4,285 shares) in the Bank for International Settlements. The nominal value of each share is 5,000 Special Drawing Rights and is 25% paid up (also note 34).

11 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2011	2010	2011	2010
At amortised cost				
Debt securities				
Listed in Hong Kong	1,496	1,014	-	-
Listed outside Hong Kong	3,030	3,025	-	-
Unlisted	3,839	4,069	-	-
TOTAL	8,365	8,108	-	-

Exchange Fund – Notes to the Financial Statements (continued)

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

12 LOAN PORTFOLIO

	Group		Fund	
	2011	2010	2011	2010
Mortgage loans, at amortised cost	31,812	34,711	-	-
Non-mortgage loans, at amortised cost	1,332	550	-	-
Allowance for loan impairment	(8)	(2)	-	-
TOTAL	33,136	35,259	-	-

13 GOLD

	Group and Fund	
	2011	2010
Gold, at market value 66,798 ounces (2010: 66,798 ounces)	817	732

14 OTHER ASSETS

	Group		Fund	
	2011	2010	2011	2010
Interest and dividends receivable	9,630	9,896	9,120	9,158
Unsettled sales and redemption of securities	5,565	7,782	5,565	7,782
Prepayments, receivables and other assets	7,877	1,906	7,391	1,642
Staff housing loans	166	188	166	188
Loan to the International Monetary Fund	284	-	284	-
TOTAL	23,522	19,772	22,526	18,770

Exchange Fund – Notes to the Financial Statements (continued)

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

15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2011	2010
Unlisted shares, at cost	2,145	2,145
Loans to subsidiaries	31,133	14,683
TOTAL	33,278	16,828

The following is a list of the principal subsidiaries as at 31 December 2011:

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 (2010: HK\$1 billion), which is callable from the Fund.

Loans to subsidiaries which principally hold investments including properties are unsecured, interest-free 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	
	2011	2010	2011	2010
Associate				
Unlisted shares, at cost	-	-	-	-
Share of post-acquisition reserves	48	47	-	-
	48	47	-	-
Joint ventures				
Unlisted shares, at cost	120	120	-	-
Due from joint ventures	3,140	3,443	-	-
Share of post-acquisition reserves	(66)	(154)	-	-
Foreign currency translation differences	22	5	-	-
	3,216	3,414	-	-
TOTAL	3,264	3,461	-	-

The Fund holds directly an associate incorporated in Hong Kong (issued share capital: HK\$10,000) which provides interbank clearing services. The Fund holds a 50% (2010: 50%) 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 a 50% (2010: 50%) 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% (2010: 51%) and 74% (2010: 74%) equity interests in these joint ventures respectively.

The Group's share of the joint ventures' assets, liabilities, income and expenses is summarised below:

	Group	
	2011	2010
Current assets	442	455
Non-current assets	8,241	7,996
Current liabilities	300	84
Non-current liabilities	5,167	4,953
Share of income	955	31
Share of expenses	867	187

Exchange Fund – Notes to the Financial Statements (continued)

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

17 INVESTMENT PROPERTIES

	Group		Fund	
	2011	2010	2011	2010
At fair value				
At 1 January	-	-	-	-
Additions	3,421	-	-	-
Change in fair value on revaluation	(134)	-	-	-
Exchange difference	(161)	-	-	-
At 31 December	3,126	-	-	-

The Group's investment properties were revalued at 31 December 2011 by investment managers. The valuation was determined principally using discounted cash flow projections based on estimates of future cash flows, supported by the terms of any existing lease and by external evidence of current market rents for similar properties in the same location. The fair value of investment properties reflects, among other things, rental income from current leases and assumptions about rental income from future leases in light of current market conditions.

The Group's investment properties are freehold properties and held outside Hong Kong.

Exchange Fund – Notes to the Financial Statements (continued)

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

The Group's investment properties are leased to third parties under operating leases. The gross rental income received and receivable by the Group and the related expenses in respect of these investment properties are summarised as follows:

	Group		Fund	
	2011	2010	2011	2010
Gross rental income	134	–	–	–
Direct expenses	(1)	–	–	–
Net rental income	133	–	–	–

The Group's total future minimum lease payments receivable under non-cancellable operating leases are as follows:

	Group		Fund	
	2011	2010	2011	2010
Within one year	184	–	–	–
After one year but not later than five years	736	–	–	–
After five years but not later than ten years	920	–	–	–
After ten years but not later than fifteen years	635	–	–	–
TOTAL	2,475	–	–	–

At 31 December 2011, investment properties with a fair value of HK\$3,126 million (2010: Nil) were pledged to secure general banking facilities granted to the Group (note 25).

Exchange Fund – Notes to the Financial Statements (continued)

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

18 PROPERTY, PLANT AND EQUIPMENT

(a)

	Group			Total
	Premises	Plant and equipment	Computer software licences and system development costs	
Cost				
At 1 January 2010	3,852	748	252	4,852
Additions	–	47	10	57
Disposals	–	(34)	–	(34)
At 31 December 2010	3,852	761	262	4,875
At 1 January 2011	3,852	761	262	4,875
Additions	–	56	17	73
Disposals	–	(5)	–	(5)
At 31 December 2011	3,852	812	279	4,943
Accumulated depreciation				
At 1 January 2010	544	469	236	1,249
Charge for the year	89	55	4	148
Written back on disposal	–	(23)	–	(23)
At 31 December 2010	633	501	240	1,374
At 1 January 2011	633	501	240	1,374
Charge for the year	87	57	7	151
Written back on disposal	–	(5)	–	(5)
At 31 December 2011	720	553	247	1,520
Net book value				
At 31 December 2011	3,132	259	32	3,423
At 31 December 2010	3,219	260	22	3,501

Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund			Total
	Premises	Plant and equipment	Computer software licences and system development costs	
Cost				
At 1 January 2010	3,843	244	252	4,339
Additions	–	34	10	44
Disposals	–	(10)	–	(10)
At 31 December 2010	3,843	268	262	4,373
At 1 January 2011	3,843	268	262	4,373
Additions	–	30	17	47
Disposals	–	(3)	–	(3)
At 31 December 2011	3,843	295	279	4,417
Accumulated depreciation				
At 1 January 2010	541	188	236	965
Charge for the year	88	18	4	110
Written back on disposal	–	(10)	–	(10)
At 31 December 2010	629	196	240	1,065
At 1 January 2011	629	196	240	1,065
Charge for the year	87	23	7	117
Written back on disposal	–	(3)	–	(3)
At 31 December 2011	716	216	247	1,179
Net book value				
At 31 December 2011	3,127	79	32	3,238
At 31 December 2010	3,214	72	22	3,308

(b) The net book value of premises comprises:

	Group		Fund	
	2011	2010	2011	2010
In Hong Kong				
Leasehold land and the building situated thereon (leasehold between 10 and 50 years)	3,109	3,196	3,104	3,191
Outside Hong Kong				
Freehold land and the building situated thereon	23	23	23	23
TOTAL	3,132	3,219	3,127	3,214

Exchange Fund – Notes to the Financial Statements (continued)

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

19 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	
	2011	2010	2011	2010
Carrying amount	258,702	225,939	9,888	8,899
Reconciliation with face value:				
Hong Kong dollar face value	259,815	226,705	9,930	8,929
Linked exchange rate for calculating the US dollars required for redemption	US\$1 = HK\$7.80	US\$1 = HK\$7.80	US\$1 = HK\$7.80	US\$1 = HK\$7.80
US dollars required for redemption	US\$33,310 million	US\$29,065 million	US\$1,273 million	US\$1,145 million
Market exchange rate for translation into Hong Kong dollars	US\$1 = HK\$7.7666	US\$1 = HK\$7.77365	US\$1 = HK\$7.7666	US\$1 = HK\$7.77365
Carrying amount	258,702	225,939	9,888	8,899

20 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.)

21 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2011	2010
At amortised cost		
Placements by central banks	24,547	23,187

22 PLACEMENTS BY FISCAL RESERVES

	Group and Fund	
	2011	2010
Placements with interest payable at a fixed rate determined annually		
General Revenue Account	342,235	309,168
Land Fund	198,140	186,925
Capital Works Reserve Fund	81,977	56,859
Civil Service Pension Reserve Fund	24,373	22,994
Disaster Relief Fund	9	47
Innovation and Technology Fund	3,067	3,444
Lotteries Fund	9,351	8,459
Capital Investment Fund	1,966	2,163
Loan Fund	2,246	2,071
	663,364	592,130
Placements with interest payable at market-based rates		
General Revenue Account	143	152
TOTAL	663,507	592,282

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 6.0% per annum for 2011 (2010: 6.3%).

Exchange Fund – Notes to the Financial Statements (continued)

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

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

	Group and Fund	
	2011	2010
Placements with interest payable at a fixed rate determined annually		
Research Endowment Fund	19,945	19,451
Bond Fund	50,944	25,088
Housing Authority	33,013	21,620
West Kowloon Cultural District Authority	11,133	10,503
Trading Funds	4,762	–
Community Care Fund	5,165	–
	124,962	76,662
Placements with interest payable at market-based rates		
Deposit Protection Scheme Fund	1,287	98
TOTAL	126,249	76,760

The fixed rate arrangement related to the placements by Fiscal Reserves also applies to certain HKSAR government funds and statutory bodies. This rate has been fixed at 6.0% per annum for 2011 (2010: 6.3%).

24 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group		Fund	
	2011	2010	2011	2010
At fair value				
Exchange Fund Bills and Notes issued				
Exchange Fund Bills	585,916	582,967	585,916	582,967
Exchange Fund Notes	72,832	72,253	72,832	72,253
	658,748	655,220	658,748	655,220
Exchange Fund Bills held	(2,998)	(1,499)	(2,998)	(999)
TOTAL	655,750	653,721	655,750	654,221

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.

Exchange Fund Bills held by the Fund as a result of market making activities are considered as redemption of the bills 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			
	2011		2010		2011		2010	
	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	583,238	69,900	464,362	69,700	583,238	69,900	464,362	69,700
Issuance	1,824,878	16,400	1,800,352	16,400	1,824,878	16,400	1,800,352	16,400
Redemption	(1,822,003)	(17,000)	(1,681,476)	(16,200)	(1,822,003)	(17,000)	(1,681,476)	(16,200)
Nominal value at 31 December	586,113	69,300	583,238	69,900	586,113	69,300	583,238	69,900
Long positions held by Financial Stability and Other Activities segment								
Nominal value at 31 December	(3,000)	-	(1,500)	-	(3,000)	-	(1,000)	-
Total nominal value	583,113	69,300	581,738	69,900	583,113	69,300	582,238	69,900
Carrying amount, at fair value	582,918	72,832	581,468	72,253	582,918	72,832	581,968	72,253
Difference	195	(3,532)	270	(2,353)	195	(3,532)	270	(2,353)

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.)

25 BANK LOANS

	Group		Fund	
	2011	2010	2011	2010
At amortised cost				
Bank loans repayable:				
After two years but not later than five years	1,876	-	-	-
	1,876	-	-	-

26 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2011	2010	2011	2010
Mortgage-backed securities issued, carried at amortised cost	367	806	-	-
Mortgage-backed securities issued, designated as fair value hedge	-	724	-	-
TOTAL	367	1,530	-	-

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	
	2011	2010	2011	2010
Total mortgage-backed securities issued				
Nominal value at 1 January	1,506	1,976	-	-
Redemption	(1,139)	(470)	-	-
Nominal value at 31 December	367	1,506	-	-
Carrying amount	367	1,530	-	-
Difference	-	(24)	-	-

27 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2011	2010	2011	2010
Debt securities issued, carried at amortised cost	3,697	4,119	-	-
Debt securities issued, designated as fair value hedge	36,469	33,044	-	-
Debt securities issued, designated at fair value	892	1,937	-	-
TOTAL	41,058	39,100	-	-

Exchange Fund – Notes to the Financial Statements (continued)

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

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	
	2011	2010	2011	2010
Total debt securities issued				
Nominal value at 1 January	38,443	43,989	-	-
Issuance	28,549	8,280	-	-
Redemption	(26,719)	(13,831)	-	-
Foreign currency translation difference	-	5	-	-
Nominal value at 31 December	40,273	38,443	-	-
Carrying amount	41,058	39,100	-	-
Difference	(785)	(657)	-	-
Debt securities issued, designated at fair value				
Nominal value	1,459	2,549	-	-
Carrying amount, at fair value	892	1,937	-	-
Difference	567	612	-	-

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

28 OTHER LIABILITIES

	Group		Fund	
	2011	2010	2011	2010
Unsettled purchases of securities	31,467	20,284	31,467	20,284
Accrued charges and other liabilities	6,433	6,608	376	451
Interest payable	524	821	276	327
Tax payable	136	142	-	-
Deferred tax liabilities	79	64	-	-
TOTAL	38,639	27,919	32,119	21,062

Exchange Fund – Notes to the Financial Statements (continued)

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

29 EQUITY

	Group		Fund	
	2011	2010	2011	2010
Attributable to owner of the Fund				
Accumulated surplus				
At 1 January	597,553	558,220	591,503	553,457
Surplus/(Deficit) for the year	(21,585)	39,333	(23,589)	38,046
At 31 December	575,968	597,553	567,914	591,503
Other reserves				
Revaluation reserve				
At 1 January	2,078	865	-	-
Fair value changes on available-for-sale securities:				
– revaluation	(284)	1,248	-	-
– realisation on disposal	(51)	(40)	-	-
– tax effect	(10)	(17)	-	-
Fair value changes on cash flow hedges:				
– revaluation	3	26	-	-
– transferred to income and expenditure account	10	-	-	-
– tax effect	(2)	(4)	-	-
At 31 December	1,744	2,078	-	-
Translation reserve				
At 1 January	41	(7)	-	-
Currency translation differences:				
– subsidiaries and joint ventures	1	48	-	-
At 31 December	42	41	-	-
	1,786	2,119	-	-
	577,754	599,672	567,914	591,503
Non-controlling interests				
At 1 January	272	204	-	-
Surplus for the year	15	12	-	-
Other comprehensive income for the year	1	-	-	-
Capital injection by non-controlling interests	4	67	-	-
Dividends paid to non-controlling interests	(10)	(11)	-	-
At 31 December	282	272	-	-
TOTAL	578,036	599,944	567,914	591,503

Exchange Fund – Notes to the Financial Statements (continued)

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

30 ANALYSIS OF CASH AND CASH EQUIVALENTS IN THE STATEMENT OF CASH FLOWS

	Group		Fund	
	2011	2010	2011	2010
Cash and money at call	60,564	49,579	60,138	48,911
Placements with banks and other financial institutions	171,507	153,260	161,529	148,700
Treasury bills and commercial paper	22,720	9,625	22,720	9,625
TOTAL	254,791	212,464	244,387	207,236

Reconciliation with the balance sheet

	Note	Group		Fund	
		2011	2010	2011	2010
Amounts shown in the balance sheet					
Cash and money at call	6	60,564	49,579	60,138	48,911
Placements with banks and other financial institutions	7	171,805	155,455	161,529	149,478
Financial assets designated at fair value					
Treasury bills and commercial paper	9	732,864	846,058	732,864	846,058
		965,233	1,051,092	954,531	1,044,447
Less: Amounts with original maturity beyond 3 months		(710,442)	(838,628)	(710,144)	(837,211)
Cash and cash equivalents in the statement of cash flows		254,791	212,464	244,387	207,236

Exchange Fund – Notes to the Financial Statements (continued)

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

31 OPERATING SEGMENT INFORMATION

The Group determines its operating segments based on the reports reviewed by the chief operating decision maker. As a central banking institution, the HKMA is responsible for managing the Exchange Fund and maintaining the monetary and banking stability of Hong Kong. The Group comprises operating segments as stated in note 2.18.

	Group							
	Currency Board Operations (note 31(a))		Reserves Management		Financial Stability and Other Activities		Total	
	2011	2010	2011	2010	2011	2010	2011	2010
Income								
Interest and dividend income	5,515	5,642	23,920	22,074	1,186	1,241	30,621	28,957
Investment gains/(losses)	10,914	6,913	(16,217)	45,833	126	99	(5,177)	52,845
Other income	-	-	21	24	896	736	917	760
	16,429	12,555	7,724	67,931	2,208	2,076	26,361	82,562
Expenditure								
Interest expense	1,667	1,815	42,761	37,846	204	172	44,632	39,833
Other expenses	774	764	858	784	1,571	1,504	3,203	3,052
	2,441	2,579	43,619	38,630	1,775	1,676	47,835	42,885
Surplus/(Deficit) before share of profit/(loss) of associate and joint ventures	13,988	9,976	(35,895)	29,301	433	400	(21,474)	39,677
Share of profit/(loss) of associate and joint ventures, net of tax	-	-	85	(158)	4	4	89	(154)
Surplus/(Deficit) before taxation	13,988	9,976	(35,810)	29,143	437	404	(21,385)	39,523
Income tax	-	-	(5)	-	(180)	(178)	(185)	(178)
Surplus/(Deficit) for the year	13,988	9,976	(35,815)	29,143	257	226	(21,570)	39,345
Attributable to:								
Owner of the Fund	13,988	9,976	(35,814)	29,146	241	211	(21,585)	39,333
Non-controlling interests	-	-	(1)	(3)	16	15	15	12
	13,988	9,976	(35,815)	29,143	257	226	(21,570)	39,345

Exchange Fund – Notes to the Financial Statements (continued)

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

	Currency Board Operations (note 31(a))		Reserves Management		Group Financial Stability and Other Activities		Re-allocation (note 31(b) & (c))		Total	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
Assets										
Backing Assets										
Investment in designated US dollar assets	1,183,554	1,119,691	-	-	-	-	-	-	1,183,554	1,119,691
Interest receivable on designated US dollar assets	1,728	1,404	-	-	-	-	-	-	1,728	1,404
Net accounts receivable/(payable)	(13,330)	-	-	-	-	-	17,447	-	4,117	-
Other investments	-	-	1,220,734	1,142,354	115,648	113,338	(2,998)	(1,499)	1,333,384	1,254,193
Other assets	-	-	17,481	18,526	6,502	6,101	1,472	541	25,455	25,168
TOTAL ASSETS	1,171,952	1,121,095	1,238,215	1,160,880	122,150	119,439	15,921	(958)	2,548,238	2,400,456
Liabilities										
Monetary Base										
Certificates of Indebtedness	258,702	225,939	-	-	-	-	-	-	258,702	225,939
Government-issued currency notes and coins in circulation	9,888	8,899	-	-	-	-	-	-	9,888	8,899
Balance of the banking system	148,684	148,702	-	-	-	-	-	-	148,684	148,702
Exchange Fund Bills and Notes issued	658,748	655,220	-	-	-	-	(2,998)	(1,499)	655,750	653,721
Interest payable on Exchange Fund Notes	276	327	-	-	-	-	-	-	276	327
Net accounts (receivable)/payable	(1,471)	(355)	-	-	-	-	1,472	541	1	186
Mortgage-backed securities issued	-	-	-	-	367	1,530	-	-	367	1,530
Other debt securities issued	-	-	-	-	41,058	39,100	-	-	41,058	39,100
Placements by banks and other financial institutions	-	-	-	-	24,547	23,187	-	-	24,547	23,187
Bank loans	-	-	1,876	-	-	-	-	-	1,876	-
Placements by Fiscal Reserves	-	-	663,507	592,282	-	-	-	-	663,507	592,282
Placements by HKSAR government funds and statutory bodies	-	-	124,962	76,662	1,287	98	-	-	126,249	76,760
Other liabilities	-	-	14,977	22,495	6,873	7,384	17,447	-	39,297	29,879
Total liabilities	1,074,827	1,038,732	805,322	691,439	74,132	71,299	15,921	(958)	1,970,202	1,800,512

Exchange Fund – Notes to the Financial Statements (continued)

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

	Currency Board Operations (note 31(a))		Reserves Management		Group Financial Stability and Other Activities		Re-allocation (note 31(b) & (c))		Total	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
	Accumulated surplus									
At 1 January	82,363	71,623	467,499	471,847	47,691	14,750	-	-	597,553	558,220
Surplus/(Deficit) for the year attributable to owner of the Fund	13,988	9,976	(35,814)	29,146	241	211	-	-	(21,585)	39,333
Allocation between segments	774	764	(346)	(33,494)	(428)	32,730	-	-	-	-
At 31 December	97,125	82,363	431,339	467,499	47,504	47,691	-	-	575,968	597,553
Other reserves	-	-	1,486	1,878	300	241	-	-	1,786	2,119
Non-controlling interests	-	-	68	64	214	208	-	-	282	272
Total equity	97,125	82,363	432,893	469,441	48,018	48,140	-	-	578,036	599,944
TOTAL LIABILITIES AND EQUITY	1,171,952	1,121,095	1,238,215	1,160,880	122,150	119,439	15,921	(958)	2,548,238	2,400,456

(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.

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. The Backing Ratio stood at 108.92% as at 31 December 2011 (2010: 107.85%).

(b) 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.

The Backing Assets are presented on a net basis in the Currency Board Operations. Accounts payable for unsettled purchases of securities are included in "net accounts payable" to offset corresponding investments in the Backing Assets. As at 31 December 2011, deductions from the Backing Assets comprised "other liabilities" of HK\$17,447 million (2010: Nil).

Exchange Fund – Notes to the Financial Statements (continued)

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

The Monetary Base is also presented on a net basis. 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\$29 million (2010: HK\$22 million) and revaluation gains of HK\$1,443 million (2010: HK\$519 million) on these interest rate swaps are included in “net accounts (receivable)/payable” to reduce the Monetary Base. As at 31 December 2011, deductions from the Monetary Base comprised “other assets” of HK\$1,472 million (2010: HK\$541 million).

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

32 PLEDGED ASSETS

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

	Note	Group		Fund	
		2011	2010	2011	2010
Secured liabilities					
Stock index futures contracts – notional amount	8(b)	37,154	32,664	37,154	32,664
Bond futures contracts – notional amount	8(b)	11,638	7,818	11,638	7,818
Interest rate futures contracts – notional amount	8(b)	3,489	2,909	3,489	2,909
Bank loans	25	1,876	–	–	–
Mortgage-backed securities issued	26	367	1,530	–	–
Assets pledged					
Financial assets designated at fair value		5,157	3,385	5,157	3,385
Held-to-maturity securities		–	278	–	–
Placements with banks		–	28	–	–
Investment properties		3,126	–	–	–
Mortgage loans		529	1,185	–	–

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.)

33 COMMITMENTS

(a) Capital commitments

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

	Group		Fund	
	2011	2010	2011	2010
Contracted for	1	1	1	1
Authorised but not yet contracted for	165	156	151	135
	166	157	152	136

(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. The facility is subject to periodic review and renewal. As at 31 December 2011, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$4,054 million equivalent (2010: HK\$4,070 million equivalent), in the form of a loan bearing prevailing market interest rates. The outstanding principal due from the IMF under the NAB amounted to HK\$284 million equivalent with a repayment term of five years (2010: 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\$120 billion (2010: 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 2011, there was no outstanding balance due from the HKDPB under this facility (2010: Nil).

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

The Fund has provided the HKMC with a revolving credit facility of HK\$30 billion (2010: HK\$30 billion) at prevailing market interest rates. As at 31 December 2011, there was no outstanding balance due from the HKMC under this facility (2010: Nil).

(e) Repurchase agreements with other central banks

The Fund has entered into bilateral repurchase agreements with various central banks in Asia and Australasia amounting up to HK\$44,658 million equivalent (2010: HK\$44,699 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2011, there was no outstanding transaction with any central bank under this arrangement (2010: Nil).

Exchange Fund – Notes to the Financial Statements (continued)

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

(f) Chiang Mai Initiative Multilateralisation Agreement

The Chiang Mai Initiative Multilateralisation (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 with a total size of US\$120 billion. 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 2011, 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 for a term of three years. This swap agreement was renewed in November 2011 for another three years and will expire in November 2014, with its size expanded from RMB200 billion/HK\$227 billion to RMB400 billion/HK\$490 billion. The renewal and expansion of the currency swap agreement will facilitate the further development of offshore renminbi business in Hong Kong. The HKMA activated the currency swap in 2010 to support renminbi trade settlement in Hong Kong. The bilateral swap outstanding as at 31 December 2011 was RMB20 billion (2010: RMB20 billion).

(h) Investment commitments

The Group's subsidiaries with principal activities for holding investment including properties had investment commitment of HK\$56,024 million equivalent as at 31 December 2011 (2010: HK\$23,273 million equivalent).

(i) Lease commitments

As at 31 December 2011, the total future minimum lease payments payable under non-cancellable operating leases of premises were as follows:

	Group		Fund	
	2011	2010	2011	2010
Within one year	56	34	42	33
After one year but not later than five years	52	35	25	35
TOTAL	108	69	67	68

(j) Financial Dispute Resolution Centre Limited

The Financial Services and the Treasury Bureau (FSTB), the HKMA and Securities and Futures Commission (SFC) have agreed to contribute the set-up costs and the operating costs of the Financial Dispute Resolution Centre Limited (FDRCL) for the first three years from 1 January 2012 to 31 December 2014. The HKMA signed a Memorandum of Understanding regarding the relevant funding arrangement with the FSTB and SFC on 21 December 2011. Up to 31 December 2011, the Fund had contributed HK\$4 million to FDRCL (2010: Nil). The outstanding commitment of the Fund to contribute to FDRCL as at 31 December 2011 was HK\$42 million (2010: Nil).

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

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

34 CONTINGENT LIABILITIES

As at 31 December 2011, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$192 million equivalent (2010: 16.1 million Special Drawing Rights or HK\$192 million equivalent), in respect of the uncalled portion of its 4,285 shares (2010: 4,285 shares) in the Bank for International Settlements (note 10).

35 MATERIAL RELATED PARTY TRANSACTIONS

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

In addition to the transactions and balances disclosed elsewhere in these financial statements, during the year, the Group, through the HKMC, purchased HK\$118 million (2010: HK\$154 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. Transactions with companies related to members of the EFAC and its Sub-Committees, if any, have been conducted as a normal part of the operation of the Group and on terms consistent with its ongoing operations.

36 FINANCIAL RISK MANAGEMENT

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

36.1 Governance

The Financial Secretary is advised by the EFAC in his control of the Fund. The EFAC is established under section 3(1) of the Exchange Fund Ordinance, which requires the Financial Secretary to consult the Committee in his exercise of control of the Fund. Members of the EFAC are appointed in a personal capacity by the Financial Secretary under the delegated authority of the Chief Executive of the HKSAR for the expertise and experience that they can bring to the Committee. Such expertise and experience include knowledge of monetary, financial and economic affairs and of investment issues, as well as of accounting, management, business and legal matters.

The EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through the EFAC.

Among these Sub-Committees, the Investment Sub-Committee (ISC) monitors the HKMA's investment management activities and makes recommendations on the investment policy and strategy of the Fund and on risk management and other related matters. Operating within the policies and guidelines endorsed by the EFAC, the Reserves Management Department of the HKMA conducts the day-to-day investment management and risk management of the Fund.

Exchange Fund – Notes to the Financial Statements (continued)

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

36.2 Investment management and control

Investment activities of the Fund are conducted in accordance with the investment benchmark derived from the Fund's investment objectives. The investment benchmark directs the 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:

	2011	2010
Asset type		
Bonds	75%	75%
Equities and related investments	25%	25%
	100%	100%
Currency		
US dollar and Hong Kong dollar	81%	82%
Others ¹	19%	18%
	100%	100%

¹ Other currencies included mainly Australian dollar, Canadian dollar, euro, sterling 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.)

36.3 Credit risk

Credit risk is the risk of financial loss when a counterparty or a borrower fails to meet its contractual obligations. The Group's credit risk arises principally from the investments of the Fund and the loan portfolio of the HKMC.

36.3.1 Management of credit risk

The HKMA maintains effective credit risk management over the investments of the Fund. Based on the delegated authority of the EFAC, the Credit Review and Compliance Committee (CRCC) was established within the HKMA with the following responsibilities: (i) to establish and maintain the Credit Exposure Policy to govern the investments of the Fund; (ii) to review the adequacy of the existing credit risk management practices and, where necessary, formulate proposals for amendments; (iii) to conduct analysis of credit risk issues; (iv) to establish and review credit limits for the approved issuers and counterparties; and (v) to monitor the compliance of the investments of the Fund with the established policies and limits, and report and follow up any identified breaches. The CRCC is chaired by the Deputy Chief Executive (Monetary) whose responsibilities are independent of the day-to-day investment activities of the Fund, and includes representatives from both the Reserves Management Department and the Monetary Management Department of the HKMA.

In 2011, despite the increased volatility in financial markets, the HKMA took effective measures to control its credit risk exposure. In light of the rapidly evolving risk environment, the HKMA will remain vigilant in monitoring and managing 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.)

36.3.2 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	
		2011	2010	2011	2010
Cash and money at call	6	60,564	49,579	60,138	48,911
Placements with banks and other financial institutions	7	171,805	155,455	161,529	149,478
Derivative financial instruments	8(a)	4,355	3,299	2,796	1,902
Debt securities designated at fair value	9	1,853,575	1,711,057	1,844,395	1,706,655
Available-for-sale debt securities	10	294	1,435	–	–
Held-to-maturity securities	11	8,365	8,108	–	–
Loan portfolio	12	33,136	35,259	–	–
Other assets	14	23,522	19,772	22,526	18,770
Loans to subsidiaries	15	–	–	31,133	14,683
Due from joint ventures	16	3,140	3,443	–	–
Risk in force – mortgage insurance	36.6	16,624	17,626	–	–
Risk in force – other guarantee and insurance		875	4	–	–
Loan commitments and other credit related commitments		257,119	144,691	231,095	151,418
TOTAL		2,433,374	2,149,728	2,353,612	2,091,817

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.)

36.3.3 Credit quality

The Group predominantly invests in liquid Organisation for Economic Co-operation and Development (OECD) government bonds and other quasi-government debt securities issues. The value of debt securities held by the Group which was rated “triple-A” by both Moody’s and Standard & Poor’s reduced from 92.4% at 31 December 2010 to 28.6% at 31 December 2011, principally as a result of the downgrade of the long-term sovereign credit rating of the United States of America and related government agencies’ debt obligations from “AAA” to “AA+”. Despite this, the credit quality of major financial assets remained strong as set out below:

	Group		Fund	
	2011	2010	2011	2010
Cash and money at call, placements with banks and other financial institutions, by credit rating¹				
AAA	697	39,487	697	39,487
AA- to AA+	99,452	69,720	98,127	68,800
A- to A+	105,714	71,024	97,336	65,591
Lower than A- or un-rated ²	26,506	24,803	25,507	24,511
	232,369	205,034	221,667	198,389
Debt securities, by credit rating¹				
AAA	531,990	1,590,105	529,543	1,586,920
AA- to AA+	1,172,266	59,139	1,166,838	53,154
A- to A+	9,432	12,752	8,648	12,379
Lower than A- or un-rated ²	148,546	58,604	139,366	54,202
	1,862,234	1,720,600	1,844,395	1,706,655
Loan portfolio				
Neither past due nor impaired (note 36.3.3(a))	32,707	34,648	-	-
Past due but not impaired (note 36.3.3(b))	432	613	-	-
Impaired (note 36.3.3(c))	5	-	-	-
Allowance for loan impairment	(8)	(2)	-	-
	33,136	35,259	-	-
TOTAL	2,127,739	1,960,893	2,066,062	1,905,044

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

² These included 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 3 include loans with no previous past due experience and with different levels of credit enhancements in addition to the collateral. Grade 4 includes loans with previous past due experience and with different levels of credit enhancements in addition to the collateral. Grade 5 includes loans with previous 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	
	2011	2010	2011	2010
Grades				
1 to 3	32,693	34,621	-	-
4	-	-	-	-
5	14	27	-	-
TOTAL	32,707	34,648	-	-

(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	
	2011	2010	2011	2010
Loans that were past due				
90 days or less	430	610	-	-
91 to 180 days	1	2	-	-
over 180 days	1	1	-	-
TOTAL	432	613	-	-
Fair value of collateral and other credit enhancements	2,358	2,529	-	-

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 2011, the fair value of related collateral held and credit enhancement was HK\$14 million (2010: HK\$0.4 million).

36.3.4 Concentration of credit risk

The majority of the Group's debt holdings are highly liquid securities issued or guaranteed by OECD governments and other quasi-government entities. The maximum credit risk exposure (note 36.3.2) by industry groups is analysed below:

	Group		Fund	
	2011	2010	2011	2010
Governments and government agencies ¹	1,681,766	1,677,684	1,680,862	1,676,894
Supra-nationals	115,688	82,472	115,665	82,449
States, provinces and public-sector entities ²	175,424	73,105	204,530	102,241
Financial institutions	188,087	152,899	171,892	139,144
Others ³	272,409	163,568	180,663	91,089
TOTAL	2,433,374	2,149,728	2,353,612	2,091,817

¹ These included debt securities guaranteed by governments.

² These included debt securities guaranteed by states.

³ These included debt securities issued by the Bank for International Settlements.

36.4 Market risk

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

36.4.1 Types of market risk

(a) Interest rate risk

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

Exchange Fund – Notes to the Financial Statements (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 mainly 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 prices. The Group's equity and related investments are subject to price risk since the value of these investments will decline if market prices or valuation fall.

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

36.4.2 Management of market risk

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

Exchange Fund – Notes to the Financial Statements (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.)

36.4.3 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 – 2011							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	
Assets								
Cash and money at call	35,658	-	-	-	-	-	35,658	24,906
Placements with banks and other financial institutions	166,212	5,593	-	-	-	-	171,805	-
Financial assets designated at fair value	216,774	248,887	393,380	562,752	244,535	178,047	1,844,375	368,022
Available-for-sale securities	-	294	-	-	-	-	294	23,170
Held-to-maturity securities	-	144	780	3,967	3,474	-	8,365	-
Loan portfolio	30,645	2,389	63	25	14	-	33,136	-
Interest-bearing assets	449,289	257,307	394,223	566,744	248,023	178,047	2,093,633	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	24,547
Placements by Fiscal Reserves with interest payable at market-based rates ¹	143	-	-	-	-	-	143	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	1,287	-	-	-	-	-	1,287	-
Exchange Fund Bills and Notes issued	134,702	320,349	145,132	40,547	8,763	6,257	655,750	-
Bank loans	1,876	-	-	-	-	-	1,876	-
Mortgage-backed securities issued	367	-	-	-	-	-	367	-
Other debt securities issued	10,804	4,204	7,290	13,828	3,637	1,295	41,058	-
Interest-bearing liabilities	149,179	324,553	152,422	54,375	12,400	7,552	700,481	
Net interest-bearing assets/(liabilities)	300,110	(67,246)	241,801	512,369	235,623	170,495	1,393,152	
Interest rate derivatives (net position, notional amounts)	(10,367)	(25,765)	8,257	13,451	8,685	5,837	98	
Interest rate sensitivity gap	289,743	(93,011)	250,058	525,820	244,308	176,332	1,393,250	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 22 and 23). The fixed rate is determined every January. As at 31 December 2011, such placements amounted to HK\$788,326 million (2010: HK\$668,792 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

	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	
Assets								
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	-
Interest-bearing assets	373,257	300,348	473,313	416,361	223,062	146,118	1,932,459	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	23,187
Placements by Fiscal Reserves with interest payable at market-based rates ¹	152	-	-	-	-	-	152	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	98	-	-	-	-	-	98	-
Exchange Fund Bills and Notes issued	133,239	318,415	147,091	42,440	8,368	4,168	653,721	-
Mortgage-backed securities issued	806	724	-	-	-	-	1,530	-
Other debt securities issued	6,863	4,863	9,276	13,052	3,776	1,270	39,100	-
Interest-bearing liabilities	141,158	324,002	156,367	55,492	12,144	5,438	694,601	
Net interest-bearing assets/(liabilities)	232,099	(23,654)	316,946	360,869	210,918	140,680	1,237,858	
Interest rate derivatives (net position, notional amounts)	(12,049)	(23,868)	12,428	11,250	8,892	3,600	253	
Interest rate sensitivity gap	220,050	(47,522)	329,374	372,119	219,810	144,280	1,238,111	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 22 and 23). The fixed rate is determined every January. As at 31 December 2011, such placements amounted to HK\$788,326 million (2010: HK\$668,792 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2011							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	
Assets								
Cash and money at call	35,280	-	-	-	-	-	35,280	24,858
Placements with banks and other financial institutions	157,685	3,844	-	-	-	-	161,529	-
Financial assets designated at fair value	215,675	248,108	393,321	562,106	243,034	178,039	1,840,283	362,934
Interest-bearing assets	408,640	251,952	393,321	562,106	243,034	178,039	2,037,092	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	24,547
Placements by Fiscal Reserves with interest payable at market-based rates ¹	143	-	-	-	-	-	143	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	1,287	-	-	-	-	-	1,287	-
Exchange Fund Bills and Notes issued	134,702	320,349	145,132	40,547	8,763	6,257	655,750	-
Interest-bearing liabilities	136,132	320,349	145,132	40,547	8,763	6,257	657,180	
Net interest-bearing assets/(liabilities)	272,508	(68,397)	248,189	521,559	234,271	171,782	1,379,912	
Interest rate derivatives (net position, notional amounts)	-	(13,400)	1,000	2,000	5,600	4,800	-	
Interest rate sensitivity gap	272,508	(81,797)	249,189	523,559	239,871	176,582	1,379,912	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 22 and 23). The fixed rate is determined every January. As at 31 December 2011, such placements amounted to HK\$788,326 million (2010: HK\$668,792 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	
Assets								
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
Interest-bearing assets	339,308	288,856	472,115	411,480	219,589	146,103	1,877,451	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	23,187
Placements by Fiscal Reserves with interest payable at market-based rates ¹	152	-	-	-	-	-	152	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹	98	-	-	-	-	-	98	-
Exchange Fund Bills and Notes issued	133,739	318,415	147,091	42,440	8,368	4,168	654,221	-
Interest-bearing liabilities	133,989	318,415	147,091	42,440	8,368	4,168	654,471	
Net interest-bearing assets/(liabilities)	205,319	(29,559)	325,024	369,040	211,221	141,935	1,222,980	
Interest rate derivatives (net position, notional amounts)	-	(10,045)	3,321	(1,241)	4,365	3,600	-	
Interest rate sensitivity gap	205,319	(39,604)	328,345	367,799	215,586	145,535	1,222,980	

¹ Placements by Fiscal Reserves, HKSAR government funds and statutory bodies with interest payable at a fixed rate determined annually are excluded because their interest rate is not fixed directly on the basis of market interest rates (notes 22 and 23). The fixed rate is determined every January. As at 31 December 2011, such placements amounted to HK\$788,326 million (2010: HK\$668,792 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			
	2011		2010	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
Hong Kong dollar	216.0	1,649.1	238.0	1,533.4
US dollar	1,970.4	315.1	1,879.5	261.3
	2,186.4	1,964.2	2,117.5	1,794.7
Others ¹	361.8	6.0	283.0	5.8
TOTAL	2,548.2	1,970.2	2,400.5	1,800.5

	Fund			
	2011		2010	
	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)	Assets (in HK\$ billion)	Liabilities (in HK\$ billion)
Hong Kong dollar	186.4	1,619.2	217.0	1,496.1
US dollar	1,945.6	299.7	1,853.0	253.1
	2,132.0	1,918.9	2,070.0	1,749.2
Others ¹	356.0	1.2	275.0	4.3
TOTAL	2,488.0	1,920.1	2,345.0	1,753.5

¹ Other currencies included mainly Australian dollar, Canadian dollar, euro, renminbi, sterling and yen.

(c) Equity price risk

As at 31 December 2011 and 2010, 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.)

36.4.4 Sensitivity analysis

The Value-at-Risk 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	
	2011	2010
Value-at-Risk		
At 31 December ¹	40,224	34,854
During the year		
Average	35,358	30,996
Maximum	49,553	37,573
Minimum	27,374	26,203

¹ The amount represented 1.7% of the Fund's investments which were subject to VaR measurement as at 31 December 2011 (2010: 1.6%).

36.5 Liquidity risk

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

36.5.1 Management of liquidity risk

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

Exchange Fund – Notes to the Financial Statements (continued)

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

36.5.2 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 – 2011						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	
Non-derivative cash outflows							
Certificates of Indebtedness	258,702	-	-	-	-	-	258,702
Government-issued currency notes and coins in circulation	9,888	-	-	-	-	-	9,888
Balance of the banking system	148,684	-	-	-	-	-	148,684
Placements by banks and other financial institutions	-	24,547	-	-	-	-	24,547
Placements by Fiscal Reserves	663,507	-	-	-	-	-	663,507
Placements by HKSAR government funds and statutory bodies	59,099	-	-	47,550	19,600	-	126,249
Exchange Fund Bills and Notes issued	134,708	320,760	146,239	41,829	9,271	5,835	658,642
Bank loans	22	-	64	2,175	-	-	2,261
Mortgage-backed securities issued	8	16	131	215	-	-	370
Other debt securities issued	3,693	1,028	12,272	21,311	3,702	1,088	43,094
Other liabilities	37,469	227	30	-	-	-	37,726
Loan commitments and other credit related commitments	257,119	-	-	-	-	-	257,119
TOTAL	1,572,899	346,578	158,736	113,080	32,573	6,923	2,230,789
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- on net basis	24	-	(9)	18	27	-	60
- on gross basis							
Total outflows	21,661	71,409	5,000	8,346	-	-	106,416
Total inflows	(21,541)	(70,913)	(4,978)	(8,240)	-	-	(105,672)
TOTAL	144	496	13	124	27	-	804

Exchange Fund – Notes to the Financial Statements (continued)

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

	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	
Non-derivative cash outflows							
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
Mortgage-backed securities issued	28	49	1,297	166	-	-	1,540
Other debt securities issued	3,048	4,277	10,978	18,139	3,987	1,424	41,853
Other liabilities	26,546	239	12	-	-	-	26,797
Loan commitments and other credit related commitments	144,691	-	-	-	-	-	144,691
TOTAL	1,312,588	323,479	183,960	97,352	25,752	6,029	1,949,160
Derivative cash (inflows)/outflows							
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)
TOTAL	1,269	558	326	(27)	335	101	2,562

Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2011						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	
Non-derivative cash outflows							
Certificates of Indebtedness	258,702	-	-	-	-	-	258,702
Government-issued currency notes and coins in circulation	9,888	-	-	-	-	-	9,888
Balance of the banking system	148,684	-	-	-	-	-	148,684
Placements by banks and other financial institutions	-	24,547	-	-	-	-	24,547
Placements by Fiscal Reserves	663,507	-	-	-	-	-	663,507
Placements by HKSAR government funds and statutory bodies	59,099	-	-	47,550	19,600	-	126,249
Exchange Fund Bills and Notes issued	134,708	320,760	146,239	41,829	9,271	5,835	658,642
Other liabilities	31,502	227	30	-	-	-	31,759
Loan commitments and other credit related commitments	231,095	-	-	-	-	-	231,095
TOTAL	1,537,185	345,534	146,269	89,379	28,871	5,835	2,153,073
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
- on net basis	23	(3)	(7)	(13)	27	-	27
- on gross basis							
Total outflows	20,839	69,682	680	5,091	-	-	96,292
Total inflows	(20,725)	(69,182)	(668)	(5,001)	-	-	(95,576)
TOTAL	137	497	5	77	27	-	743

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	
Non-derivative cash outflows							
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	20,408	239	12	-	-	-	20,659
Loan commitments and other credit related commitments	151,418	-	-	-	-	-	151,418
TOTAL	1,310,601	319,153	171,685	79,047	21,765	4,605	1,906,856
Derivative cash (inflows)/outflows							
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)
TOTAL	1,268	550	341	(45)	335	101	2,550

36.6 Mortgage insurance risk

In providing mortgage insurance cover to authorized institutions in respect of mortgage loans originated by such authorized institutions and secured by residential properties, the Group faces insurance risk of the possibility 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 2011, the total risk-in-force was HK\$16.6 billion (2010: HK\$17.6 billion), of which HK\$14.1 billion (2010: HK\$15.2 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 from 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. The most significant are a downturn in the economy and a slump in local property market. Economic downturn, which may cause a rise in defaulted payment, affects the frequency of claims. A drop in property prices, where the collateral values fall below the outstanding balance of the mortgage loans, will increase the severity 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 and excess-of-loss reinsurance arrangement in an effort to limit its risk exposure. The reinsurers are selected according to prudent criteria and their credit ratings are reviewed regularly.

36.7 Operational risk

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

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

The primary responsibility for the development and implementation of controls to address operational risk rests with an internal high-level Risk Committee. The Committee is chaired by the Chief Executive of the HKMA and the three Deputy Chief Executives serve as members. The Risk Committee provides direction and guidance for line 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.)

37 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	
		2011	2010	2011	2010
Financial assets					
Held-to-maturity securities	11	8,365	8,108	8,637	8,259
Financial liabilities					
Mortgage-backed securities issued, not designated at fair value	26	367	1,530	366	1,525
Other debt securities issued, not designated at fair value	27	40,166	37,163	40,172	37,165

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 2011 and 2010.

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 – 2011			Total
	Level 1	Level 2	Level 3	
Assets				
Derivative financial instruments	534	3,821	–	4,355
Financial assets designated at fair value	1,708,280	482,130	21,987	2,212,397
Available-for-sale securities	2,009	294	20,668	22,971
	1,710,823	486,245	42,655	2,239,723
Liabilities				
Derivative financial instruments	22	913	–	935
Exchange Fund Bills and Notes issued	–	655,750	–	655,750
Other debt securities issued, designated at fair value	–	892	–	892
	22	657,555	–	657,577

	Group – 2010			Total
	Level 1	Level 2	Level 3	
Assets				
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
	1,720,578	373,815	29,703	2,124,096
Liabilities				
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
	293	657,838	–	658,131

Exchange Fund – Notes to the Financial Statements (continued)

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

	Fund – 2011			
	Level 1	Level 2	Level 3	Total
Assets				
Derivative financial instruments	534	2,262	–	2,796
Financial assets designated at fair value	1,708,280	478,428	16,509	2,203,217
	1,708,814	480,690	16,509	2,206,013
Liabilities				
Derivative financial instruments	22	650	–	672
Exchange Fund Bills and Notes issued	–	655,750	–	655,750
	22	656,400	–	656,422

	Fund – 2010			
	Level 1	Level 2	Level 3	Total
Assets				
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
Liabilities				
Derivative financial instruments	293	2,136	–	2,429
Exchange Fund Bills and Notes issued	–	654,221	–	654,221
	293	656,357	–	656,650

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).

During the year, there were no transfers of financial instruments between Level 1 and Level 2 of the fair value hierarchy.

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	
	2011	2010	2011	2010
At 1 January	20,774	27,264	8,929	3,572
Net gains/(losses) recognised in the income and expenditure account	(758)	866	-	-
Net gains/(losses) recognised in other comprehensive income	-	-	(392)	1,103
Purchases	10,912	7,525	13,160	4,452
Sales	(5,994)	(5,269)	(1,029)	(198)
Transfers into Level 3	268	7,163	-	-
Transfers out of Level 3	(3,215)	(16,775)	-	-
At 31 December	21,987	20,774	20,668	8,929
Net gains/(losses) recognised in the income and expenditure account relating to those assets held at the balance sheet date	(653)	1,300	-	-

	Fund			
	Designated at fair value		Available-for-sale	
	2011	2010	2011	2010
At 1 January	19,711	27,264	-	-
Net gains/(losses) recognised in the income and expenditure account	(786)	869	-	-
Purchases	6,210	6,459	-	-
Sales	(5,679)	(5,269)	-	-
Transfers into Level 3	268	7,163	-	-
Transfers out of Level 3	(3,215)	(16,775)	-	-
At 31 December	16,509	19,711	-	-
Net gains/(losses) recognised in the income and expenditure account relating to those assets held at the balance sheet date	(674)	1,303	-	-

During the year, certain financial instruments were transferred between Level 2 and Level 3 of the fair value hierarchy 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\$2,199 million (2010: HK\$2,077 million) and in other comprehensive income of HK\$2,067 million (2010: HK\$893 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

38 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2011

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 2011 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 HKAS 1, Presentation of Financial Statements – Presentation of Items of Other Comprehensive Income	1 July 2012
Amendments to HKAS 12, Income Taxes – Deferred Tax: Recovery of Underlying Assets	1 January 2012
HKAS 19 (2011), Employee Benefits	1 January 2013
HKAS 27 (2011), Separate Financial Statements	1 January 2013
HKAS 28 (2011), Investments in Associates and Joint Ventures	1 January 2013
Amendments to HKAS 32, Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities	1 January 2014
Amendments to HKFRS 7, Financial Instruments: Disclosures – Disclosures – Transfers of Financial Assets – Disclosures – Offsetting Financial Assets and Financial Liabilities	1 July 2011 1 January 2013
HKFRS 9, Financial Instruments	1 January 2015
HKFRS 10, Consolidated Financial Statements	1 January 2013
HKFRS 11, Joint Arrangements	1 January 2013
HKFRS 12, Disclosure of Interests in Other Entities	1 January 2013
HKFRS 13, Fair Value Measurement	1 January 2013

39 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 2 April 2012.