HONG KONG MONETARY AUTHORITY
香港金融管理局

ANNUAL REPORT 2011

Hong Kong Monetary Authority

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

The HKMA's policy objectives are

- to maintain currency stability within the framework of the Linked Exchange Rate system
- to promote the stability and integrity of the financial system, including the banking system
- to help maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure
- to manage the Exchange Fund.

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

The HKMA's offices are at

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

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

Contents

The chapter on Banking Stability in this Annual Report is the report on the working of the Banking Ordinance and the activities of the office of the Monetary Authority during 2011 submitted by the Monetary Authority to the Financial Secretary in accordance with section 9 of the Banking Ordinance.

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

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

Highlights of 2011

Economic and Financial Environment

Economic growth momentum slows in 2011 with real GDP growth moderating to 5.0% amid an increasingly austere global environment.

The Hong Kong banking sector remains robust and well capitalised, with asset quality improving further.

Monetary Stability

The Hong Kong dollar exchange rate remains stable against the US dollar. The Government reiterates its full commitment to the Linked Exchange Rate system.

The money market activities are orderly with the Hong Kong dollar interest rates increasing slightly in the second half of the year.

Banking Stability

The HKMA further strengthens the credit risk management of banks through supervisory actions, introducing the fourth round of countercyclical measures on property mortgage loans and implementing positive mortgage data sharing.

The enhanced Deposit Protection Scheme comes into operation on 1 January upon the expiry of the Government's Full Deposit Guarantee.

International Financial Centre

Hong Kong achieves remarkable progress in its development as the premier offshore renminbi business centre. The HKMA accelerates the enhancement of the renminbi RTGS system to support further expansion of renminbi market activities in Hong Kong.

The HKMA continues its efforts in developing an implementation framework on regulation for over-the-counter derivatives, including the launch of a local trade repository.

Reserves Management

The Exchange Fund records an investment income of $27.1 billion, a return of 1.1%.

Total assets of the Exchange Fund reach $2,488.0 billion at the end of 2011.

Chief Executive's Statement

At the beginning of last year I foreshadowed that the imbalances in the global financial system would continue to create uncertainties that would have profound negative consequences for the global economy and financial markets. This proved to be the prevalent theme of 2011 as markets and economies from the United States to Europe to Asia were buffeted by unpredictable volatility.

No region escaped this unsettling uncertainty. The US, the world's biggest economy, saw its positive growth momentum of late 2010 slow to a full year growth rate of only 1.7% in 2011, substantially lower than the consensus forecast of 3.2% at the start of the year. Market confidence and the outlook for the global economy worsened with the historic downgrade of the US foreign currency and local currency long-term ratings from "AAA" to "AA+" by Standard & Poor's in August 2011. The ratings agency's announcement on 5 August triggered a brief period of panic in the markets. Across the Atlantic the situation was even more worrying, with Europe's sovereign debt crisis spreading from the peripheral economies to the major ones. The situation in Asia was also uneasy. Japan experienced a devastating earthquake, tsunami and nuclear crisis. In Mainland China, despite the severe inflationary pressure and risk of asset bubble in early 2011, there was increasing concern about the possibility of a hard landing towards the end of the year.

Against this global backdrop, 2011 was a testing time for the financial stability of Hong Kong.

With the US sovereign rating downgrade and the general economic malaise spreading from the US and Europe, some concerns were expressed locally about the appropriateness of Hong Kong continuing to link the Hong Kong dollar to the US dollar through the Linked Exchange Rate system. The HKMA presented robust analyses showing that the Linked Exchange Rate system remained the most appropriate exchange rate regime for Hong Kong. Our proactive communication not only addressed the anxiety of Hong Kong people, but also earned strong support from the International Monetary Fund, which continued to express support for the Linked Exchange Rate system in its Article IV Consultation for Hong Kong undertaken at the end of last year. In addition, the Hong Kong SAR Government reaffirmed its support for the Linked Exchange Rate system as the cornerstone of Hong Kong's monetary stability and the basis for financial and economic stability.

The Global Financial Crisis taught us in the most emphatic manner that over-borrowing and the creation of asset price bubble is a recipe for financial disaster. In 2011 the HKMA maintained its vigilance against the build-up of systemic risks within the banking sector which, in the early part of the year, faced an exuberant property market and rapid expansion of credit. We implemented positive mortgage data sharing in April and introduced the fourth round of countercyclical macro-prudential measures in June, thereby strengthening banks' risk management and ability to withstand the possible shock of a significant correction in the property market. As a result of successive actions taken by the HKMA, turnover in the property market dropped significantly while price eased by 3.9% in the second half of the year. Banks became more prudent in undertaking their mortgage business. The average loan-to-value ratio for new residential mortgage loans decreased to 53% in December 2011, from 64% in September 2009 before the first round of measures was introduced; and the average debt servicing ratio for new residential mortgage loans fell to 36% in December 2011 from 41% in August 2010, when the tighter requirement on debt servicing ratio was first introduced. Meanwhile, in response to the rapid expansion of credit in other areas, the HKMA repeatedly reminded banks that their credit underwriting standards must not be diluted by strong loan demand from customers, their loan growth must be supported by stable funding sources, and they must have strong buffers against possible deterioration in asset quality. With the joint efforts of the HKMA and the banking industry, credit growth slowed in the latter half of the year.

A very positive development in 2011 was the remarkable growth of Hong Kong as the offshore renminbi business centre. Renminbi trade settled through Hong Kong totalled RMB1,915 billion in 2011, more than five times the amount settled in 2010. With increasing demand for renminbi financing, issuance of dim-sum bonds in Hong Kong tripled to RMB108 billion in 2011 with a broader range of issuers, and the outstanding amount of renminbi corporate loans increased from less than RMB2 billion at the beginning of the year to over RMB30 billion at the end of 2011. Hong Kong now possesses the largest renminbi liquidity pool outside Mainland China, with customer deposits growing from RMB315 billion at the beginning of 2011 to RMB589 billion at the end of the year, and certificates of deposits increasing more than 10 times from RMB7 billion at the beginning of 2011 to RMB73 billion at the end of the year. Such phenomenal growth was partly a result of the continued maturity of offshore renminbi businesses in Hong Kong, and partly because of the expansion of policy framework by the Mainland authorities to facilitate better use and circulation of renminbi funds between the offshore and the onshore markets.

Hong Kong's role in supporting renminbi business overseas continues to grow. Our renminbi financial platform now supports banks and financial institutions around the globe. At the end of 2011, 15% of renminbi corporate deposits were held by overseas companies. Of the 187 participating banks, 165 were foreign owned or located overseas, covering over 30 countries in six continents. In 2011 the HKMA conducted promotional roadshows in Australia, Russia, the United Kingdom and Spain to enhance the awareness of overseas corporate and financial institutions of the one-stop services offered by our platform. We also agreed with the UK Treasury in January 2012 to establish the Hong Kong-London Joint Forum to promote co-operation on development of offshore renminbi businesses. The operating hours of our renminbi Real Time Gross Settlement system will be extended to 11:30 p.m. by June 2012 to allow financial institutions in the UK and Europe to make good use of Hong Kong's offshore renminbi platform, which will in turn strengthen the status of Hong Kong as the global hub for offshore renminbi business.

The performance of the Exchange Fund in 2011 was affected by the exceptionally volatile and difficult investment environment but recorded an investment income of HK$27.1 billion, or a return of 1.1%, for the year. It was a roller-coaster year for global equity markets, which went from being strong in the first quarter of 2011 following the second round of quantitative easing and fiscal stimulus measures in the US, to shaky when the Greek sovereign debt crisis flared in May. As the European debt crisis intensified, risk appetite declined sharply and market confidence weakened significantly. A sell-off of risky assets followed the downgrade of the US sovereign credit rating in August. This drove equity markets sharply down while the US dollar strengthened, which wiped out most of the investment income gained by the Exchange Fund in the first half of the year. The Exchange Fund in the fourth quarter recouped part of its losses incurred in the third quarter, following the positive developments in Europe, including the agreement of the European leaders on a Fiscal Compact and the first round of the Longer-Term Refinancing Operations launched by the European Central Bank in December 2011.

Although confidence of the global financial markets recovered somewhat in early 2012, the outlook for the year 2012 is still fraught with uncertainty as the US and European governments grapple to restore their economies to the path of growth. Europe still faces uncertainties arising from its sovereign debt overhang and lack of growth momentum, while the US will continue to be troubled by the slow improvement in the labour and housing markets. Rising geopolitical risks around the world also present potential flashpoints for the global economy. As a result, capital flows will remain highly unpredictable and financial markets can be very volatile in 2012.

Meanwhile, quantitative easing and persistently low interest rates in the advanced economies have led to massive capital flows into emerging market economies in the past few years, fuelling over-heating pressures and heightening the risks of inflation and asset price bubble. With the advanced economies anticipating the maintenance of an accommodative monetary policy for an extended period, a two-speed global recovery will persist. On the one hand, we must prepare ourselves for any downside risks originating from Europe and the US. On the other hand, we must not loosen our guard against the risk of renewed exuberance in the property market. The crucial issue for Hong Kong is to remain alert and vigilant, and be prepared for any unexpected storms that may blow our way.

Hong Kong has a good track record of financial stability over a very long period. As challenges confront the global economy, the HKMA will continue to guard Hong Kong against threats to our banking and monetary stability. We will continue to manage the Exchange Fund in a prudent manner amid a highly uncertain investment environment, and continue the diversification of investment with a view to increasing medium- and long-term return while ensuring that the Fund has sufficient liquidity to maintain monetary and financial stability. At the same time, we will continue to work diligently to grasp the opportunities for developing Hong Kong as the offshore renminbi business centre and an asset management centre, and raising Hong Kong's standing as an international financial centre to new heights.

Norman T.L. CHAN
Chief Executive

About the HKMA

The Hong Kong Monetary Authority is Hong Kong's central banking institution. The HKMA has four main functions: maintaining currency stability within the framework of the Linked Exchange Rate system; promoting the stability and integrity of the financial system, including the banking system; helping to maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure; and managing the Exchange Fund.

THE HKMA'S LEGAL MANDATE

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

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

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

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

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

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

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

THE HKMA AND THE HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT

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

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

The Financial Secretary, assisted by the Secretary for Financial Services and the Treasury, has responsibility for policies for maintaining the stability and integrity of Hong Kong's financial system and the status of Hong Kong as an international financial centre. In support of these policies, the Monetary Authority's responsibilities include:

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

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

About the HKMA

ACCOUNTABILITY AND TRANSPARENCY

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

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

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

- to keep the financial industry and the public as fully informed about the work of the HKMA as possible, subject to considerations of market sensitivity, commercial confidentiality and statutory restrictions on disclosure of confidential information

- to ensure that the HKMA is in touch with, and responsive to, the community it serves.

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

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

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

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

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

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

About the HKMA

EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC. The Committee held six meetings in 2011 to discuss the full range of issues relating to the work of the HKMA, most of which had been previously discussed by the relevant Sub-Committees.

The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues. The Sub-Committee met five times in 2011 to consider a range of subjects including the HKMA's expenditure budget, the HKMA's performance assessment, the annual pay review, the *HKMA Annual Report*, and strategic planning matters. The Sub-Committee also received regular reports on the work of the HKMA.

The *Audit Sub-Committee* reviews and reports on the HKMA's financial reporting process and the adequacy and effectiveness of the internal control systems of the HKMA. The Sub-Committee reviews the HKMA's financial statements, and the composition and accounting principles adopted in such statements. It also examines and reviews with both the external and internal auditors the scope and results of their audits. None of the members of the Sub-Committee performs any executive functions in the HKMA. The Sub-Committee met twice in 2011 and received reports on the work of the Internal Audit Division.

The *Currency Board Sub-Committee* monitors and reports on the Currency Board arrangements that underpin Hong Kong's Linked Exchange Rate system. It is responsible for ensuring that Currency Board operations are in accordance with established policy, recommending improvements to the Currency Board system, and ensuring a high degree of transparency in the operation of the system. Records of the Sub-Committee's meetings and the reports on Currency Board operations submitted to the Sub-Committee are published. In 2011 the Sub-Committee met four times.

The *Investment Sub-Committee* monitors the HKMA's investment management work and makes recommendations on the investment policy and strategy of the Exchange Fund and on risk management and other related matters. The Sub-Committee held six meetings during 2011.

The *Financial Infrastructure Sub-Committee* makes recommendations on measures to further develop Hong Kong's status as an international financial centre and strengthen the international competitiveness of Hong Kong's financial services, including promoting the development, operational excellence, safety and efficiency of the financial infrastructure in Hong Kong; and promoting the development of Hong Kong as an offshore renminbi centre and fostering the development of other enabling factors. It also makes recommendations on initiatives for the HKMA and monitors the work of the HKMA. In 2011 the Sub-Committee met three times.

Brief biographies of EFAC Members and the Code of Conduct for EFAC Members may be found on the HKMA website. A Register of Members' Interests, which contains the declarations of interests by Members, is available for public inspection during 10:00 a.m. to 6:00 p.m. Monday to Friday (except public holidays) at the HKMA offices.

Banking Advisory Committee

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

Deposit-Taking Companies Advisory Committee

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

Chief Executive's Committee

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

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE

Chairman

The Honourable John TSANG Chun-wah, GBM, JP
The Financial Secretary

Members

Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited

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

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

Professor the Honourable Lawrence J. LAU, GBS, JP
Chairman, CIC International (Hong Kong) Co., Limited
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

Mr David SUN Tak-kei, BBS, JP

Dr John CHAN Cho-chak, GBS, JP

Mr Benjamin HUNG Pi-cheng, JP
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Peter WONG Tung-shun, JP
Chief Executive Asia Pacific
The Hongkong and Shanghai Banking
Corporation Limited

Professor CHAN Yuk-shee, BBS, JP
President
Lingnan University of Hong Kong

Mr Lester HUANG, JP
Managing Partner
P.C. Woo & Co.

Ms Teresa KO Yuk-yin, JP
Chairman, China
Freshfields Bruckhaus Deringer

Mr PANG Yiu-kai, SBS, JP
Chief Executive
Hongkong Land Holdings Limited

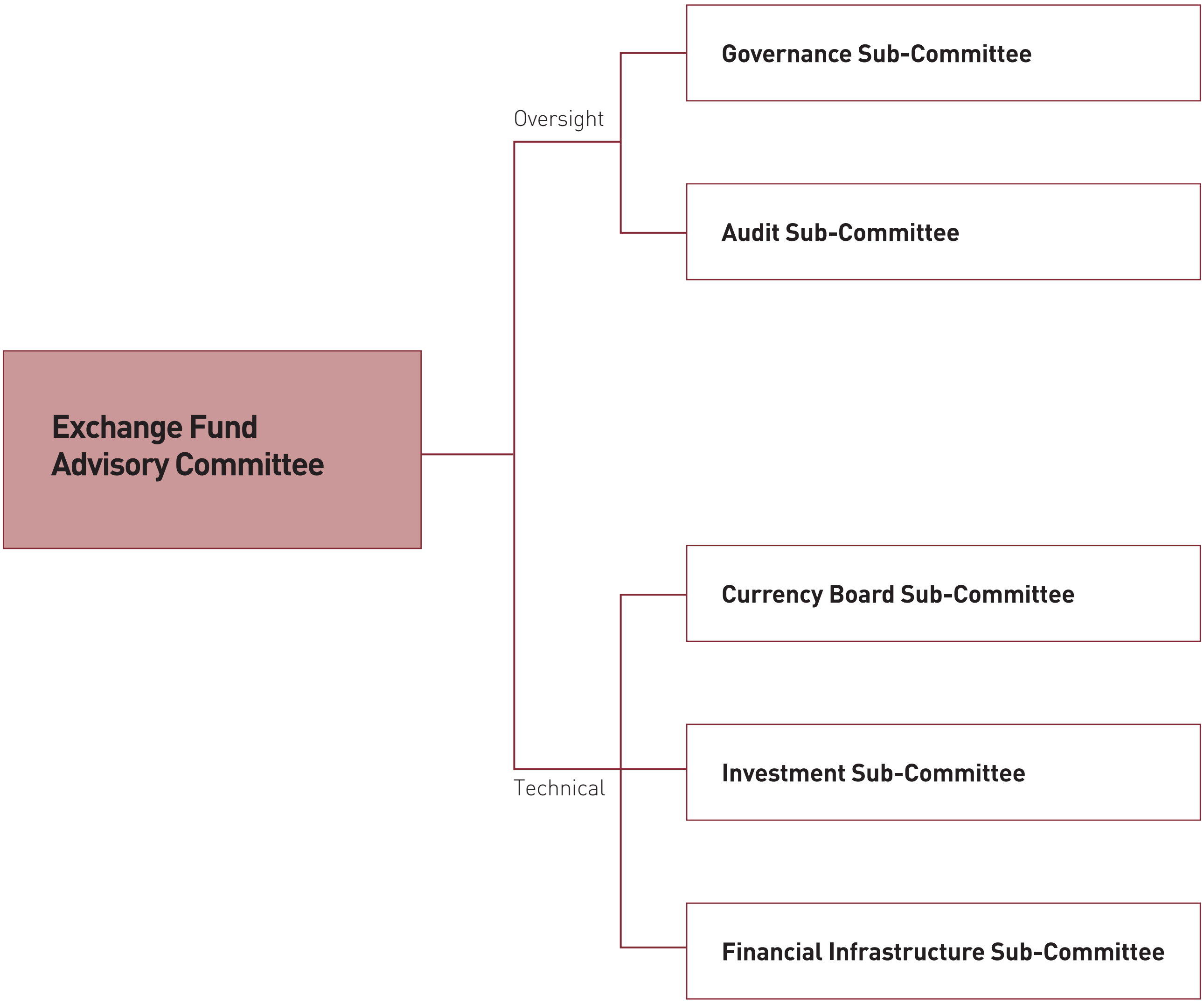
Mr Carlson TONG, JP

Dr David WONG Yau-kar, JP
Managing Director
United Overseas Investments Ltd
(from 1 November 2011)

Secretary
Mr Alan AU

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited

Members

Professor the Honourable Lawrence J. LAU, GBS, JP
Chairman, CIC International (Hong Kong) Co., Limited
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

Mr David SUN Tak-kei, BBS, JP

Dr John CHAN Cho-chak, GBS, JP

Professor CHAN Yuk-shee, BBS, JP
President
Lingnan University of Hong Kong

Mr Lester HUANG, JP
Managing Partner
P.C. Woo & Co.

Ms Teresa KO Yuk-yin, JP
Chairman, China
Freshfields Bruckhaus Deringer

Mr PANG Yiu-kai, SBS, JP
Chief Executive
Hongkong Land Holdings Limited

Mr Carlson TONG, JP

Dr David WONG Yau-kar, JP
Managing Director
United Overseas Investments Ltd
(from 1 November 2011)

Secretary

Mr Alan AU

Terms of reference

(1) To monitor the performance of the HKMA in carrying out its functions and responsibilities and in its use of resources, and to formulate recommendations to the Financial Secretary through the Exchange Fund Advisory Committee (EFAC) on

(a) the remuneration and human resources policies of the HKMA;

(b) remuneration for HKMA staff, taking account of the Sub-Committee's assessment of the quality and effectiveness of the HKMA's work; and

(c) the use of resources of the HKMA, including its annual administrative budget.

(2) To consider recommendations and provide advice to the Financial Secretary on the appointment and dismissal of staff at the level of Executive Director and above.

(3) To keep under review the governance arrangements for the HKMA and to make recommendations to the Financial Secretary through EFAC as appropriate.

THE EXCHANGE FUND ADVISORY COMMITTEE AUDIT SUB-COMMITTEE

Chairman
Mr David SUN Tak-kei, BBS, JP

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

Mr Peter WONG Tung-shun, JP
Chief Executive Asia Pacific
The Hongkong and Shanghai Banking Corporation Limited

Mr Benjamin HUNG Pi-cheng, JP
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Carlson TONG, JP

Secretary
Mr Alan AU

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

(a) to help Members of the Exchange Fund Advisory Committee to discharge their responsibilities for ensuring the proper and smooth running of the HKMA operations and management of the Exchange Fund;

(b) to consider any matters relating to the financial affairs of the HKMA and the internal and external audit of the HKMA's financial statements as the Sub-Committee may think necessary or desirable;

(c) to encourage higher quality accounting and audit and provide more credible and objective financial reporting of the HKMA; and

(d) to consider any other matters referred to it by the Committee; and to report on all such matters to the Committee.

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

(a) reviewing the HKMA's financial statements, the composition and accounting principles adopted in such statements, whether these are intended to be audited or published or not;

(b) advising on the form and content of the financial statements of the HKMA;

(c) examining and reviewing with both the external and internal auditors the scope and results of their audits;

(d) reviewing the findings, recommendations or criticisms of the auditors, including their annual management letter and management's response;

(e) reviewing the HKMA's management procedures to ensure the effectiveness of internal systems of accounting and control, and management's efforts to correct deficiencies discovered in audits; and

(f) initiating investigations or audit reviews into any activities of the HKMA which may be of concern or interest to the Sub-Committee.

(3) Authority

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

(4) Meetings

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

THE EXCHANGE FUND ADVISORY COMMITTEE CURRENCY BOARD SUB-COMMITTEE

Chairman

Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority

Members

Mr Peter PANG, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Arthur YUEN, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Professor TSANG Shu-ki
Senior Research Fellow
Institute for Enterprise Development
School of Business
Hong Kong Baptist University

Mr HE Guangbei, JP
Chairman
The Hong Kong Association of Banks

Professor XIE Danyang
Professor
Department of Economics
The Hong Kong University of Science and Technology

Mr Eddie YUE, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Dr John GREENWOOD
Group Chief Economist
INVESCO Asset Management Limited

Professor the Honourable Lawrence J. LAU, GBS, JP
Chairman, CIC International (Hong Kong) Co., Limited
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

Mr KWOK Kwok-chuen, BBS, JP
Honorary Senior Research Fellow
School of Economics and Finance
The University of Hong Kong

Dr David WONG Yau-kar, JP
Managing Director
United Overseas Investments Ltd
(from 1 November 2011)

Secretary

Mr Alan AU

Terms of reference

(1) To ensure that the operation of the Currency Board arrangements in Hong Kong is in accordance with the policies determined by the Financial Secretary in consultation with the Exchange Fund Advisory Committee.

(2) To report to the Financial Secretary through the Exchange Fund Advisory Committee on the operation of the Currency Board arrangements in Hong Kong.

(3) To recommend, where appropriate, to the Financial Secretary through the Exchange Fund Advisory Committee, measures to enhance the robustness and effectiveness of the Currency Board arrangements in Hong Kong.

(4) To ensure a high degree of transparency in the operation of the Currency Board arrangements in Hong Kong through the publication of relevant information on the operation of such arrangements.

(5) To promote a better understanding of the Currency Board arrangements in Hong Kong.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE INVESTMENT SUB-COMMITTEE

Chairman

Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority

Members

Mr Eddie YUE, JP
Deputy Chief Executive
Hong Kong Monetary Authority

Mr Benjamin HUNG Pi-cheng, JP
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited

Mr Peter WONG Tung-shun, JP
Chief Executive Asia Pacific
The Hongkong and Shanghai Banking Corporation Limited

Ms Teresa KO Yuk-yin, JP
Chairman, China
Freshfields Bruckhaus Deringer

Mr Carlson TONG, JP
(from 5 September 2011)

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited

Dr John CHAN Cho-chak, GBS, JP

Professor CHAN Yuk-shee, BBS, JP
President
Lingnan University of Hong Kong

Mr PANG Yiu-kai, SBS, JP
Chief Executive
Hongkong Land Holdings Limited

Mr HE Guangbei, JP
Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited
(until 25 June 2011)

Secretary

Mr Alan AU

Terms of reference

(1) To monitor the investment management work of the HKMA.

(2) To make recommendations to the Financial Secretary, through the Exchange Fund Advisory Committee, on

(a) the investment benchmark for the Exchange Fund;

(b) the investment policy and risk management of the Fund;

(c) the investment strategy for the Fund; and

(d) any other matters referred to the Sub-Committee in connection with the investment management of the Exchange Fund.

THE EXCHANGE FUND ADVISORY COMMITTEE FINANCIAL INFRASTRUCTURE SUB-COMMITTEE

Chairman

Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority

Members

Mr Peter PANG, JP
Deputy Chief Executive
Hong Kong Monetary Authority
(from 1 July 2011)

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited

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

Ms Anita FUNG Yuen-mei
Group General Manager
Chief Executive Officer Hong Kong
The Hongkong and Shanghai Banking Corporation Limited
(from 1 July 2011)

Mr LAU Ming-wai, JP
Vice Chairman
Chinese Estates Holdings Limited
(from 1 July 2011)

Mr Peter WONG Tung-shun, JP
Chief Executive Asia Pacific
The Hongkong and Shanghai Banking Corporation Limited
(until 30 June 2011)

Mr Eddie YUE, JP
Deputy Chief Executive
Hong Kong Monetary Authority

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

Mr Lester HUANG, JP
Managing Partner
P.C. Woo & Co.

Mr Lawrence LAM Yuk-kun
Chairman, Greater China
The Royal Bank of Scotland
(from 1 July 2011)

Mr TSE Kam-keung
Senior Advisor – Asia Pacific
State Street Bank and Trust Company
(from 1 July 2011)

Secretary

Mr Alan AU

Terms of reference

(1) To recommend to the Financial Secretary through the Exchange Fund Advisory Committee measures to further develop Hong Kong's status as an international financial centre and strengthen the international competitiveness of Hong Kong's financial services, including –

(a) measures to promote the development, operational excellence, safety and efficiency of the financial infrastructure in Hong Kong, particularly payment and settlement arrangements;

(b) measures to promote the development of Hong Kong as an offshore renminbi centre;

(c) measures to foster the development of other enabling factors that would help enhance the competitiveness of Hong Kong's financial services; and

(d) initiatives for the HKMA, in discharging its responsibilities for maintaining the stability and integrity of the monetary and financial systems of Hong Kong, to promote the development of the financial infrastructure and financial markets in Hong Kong under (a) to (c) above.

(2) To monitor the work of the HKMA in relation to the initiatives identified in (1) above.

Advisory Committees

THE BANKING ADVISORY COMMITTEE

Chairman

The Honourable John TSANG Chun-wah, GBM, JP
The Financial Secretary

Ex Officio Member

Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority

Members

Professor the Honourable K C CHAN, SBS, JP
Secretary for Financial Services and the Treasury

Mr Benjamin HUNG Pi-cheng, JP
Executive Director and Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
Representing Standard Chartered Bank (Hong Kong) Limited

Ms Anita FUNG Yuen-mei
Group General Manager
Chief Executive Officer Hong Kong
The Hongkong and Shanghai Banking Corporation Limited
Representing The Hongkong and Shanghai Banking Corporation Limited
(from 12 September 2011)

Dr the Honourable David LI Kwok-po, LLD, GBM, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited

Mrs Kathryn SHIH
Chief Executive
Hong Kong Branch
UBS AG

Mr Stanley WONG Yuen-fai, JP
Director and Deputy General Manager
Industrial and Commercial Bank of China (Asia) Limited
(until 19 August 2011)

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Vice Chairman and Chief Executive
Bank of China (Hong Kong) Limited
Representing Bank of China (Hong Kong) Limited

Mr Mark S MCCOMBE
Chief Executive Officer Hong Kong
The Hongkong and Shanghai Banking Corporation Limited
Representing The Hongkong and Shanghai Banking Corporation Limited
(until 8 September 2011)

Mr Eddy FONG Ching, GBS, JP
Chairman
Securities and Futures Commission
Representing Securities and Futures Commission

Mr Hidemitsu OTSUKA
Executive Officer, Regional Head for Hong Kong and General Manager
The Bank of Tokyo-Mitsubishi UFJ, Limited
Hong Kong Branch

Mr Weber LO Wai-pak
Chief Executive Officer and Country Business Manager
Citibank (Hong Kong) Limited
(from 1 December 2011)

Secretary

Ms Jasmin FUNG

THE DEPOSIT-TAKING COMPANIES ADVISORY COMMITTEE

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The Financial Secretary

Ex Officio Member

Mr Norman T.L. CHAN, SBS, JP
The Monetary Authority

Members

Professor the Honourable K C CHAN, SBS, JP
Secretary for Financial Services and the Treasury

Mr Ryan FUNG Yuk-lung
Chairman
The DTC Association (The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies)
Representing The DTC Association
(until 31 August 2011)

Mr LEE Huat-oon
Acting Chairman
The DTC Association (The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies)
Representing The DTC Association
(from 2 December 2011)

Ms Connie LAU Yin-hing, JP
Chief Executive
Consumer Council
Representing the Consumer Council

The Honourable CHAN Kam-lam, SBS, JP
Member
Legislative Council

Mr Frederick CHIN Voon-fat
Chief Executive
Banc of America Securities Asia Limited

Mr LEE Huat-oon
General Manager/Chief Executive
Public Finance Limited

Ms Miranda KWOK Pui-fong
Director
China Construction Bank (Asia) Finance Limited

Ms Joan HO Yuk-wai
Partner
Financial Services
KPMG

Secretary

Ms Jasmin FUNG

Chief Executive's Committee

Norman T.L. CHAN, SBS, JP
Chief Executive

Peter PANG, JP
Deputy Chief Executive

Eddie YUE, JP
Deputy Chief Executive

Arthur YUEN, JP
Deputy Chief Executive

Stefan GANNON, JP
General Counsel

Raymond LI, JP
Director-General (Enforcement)

Edmond LAU, JP
Executive Director (Monetary Management)

Francis CHU, JP
Executive Director (Reserves Management)

Esmond LEE, JP
Executive Director (Financial Infrastructure)

Karen KEMP, JP
Executive Director (Banking Policy)

Nelson MAN, JP
Executive Director (Banking Supervision)

Dong HE, JP
Executive Director (Research)

Meena DATWANI, JP
Executive Director (Banking Conduct)

Chief Executive's Committee

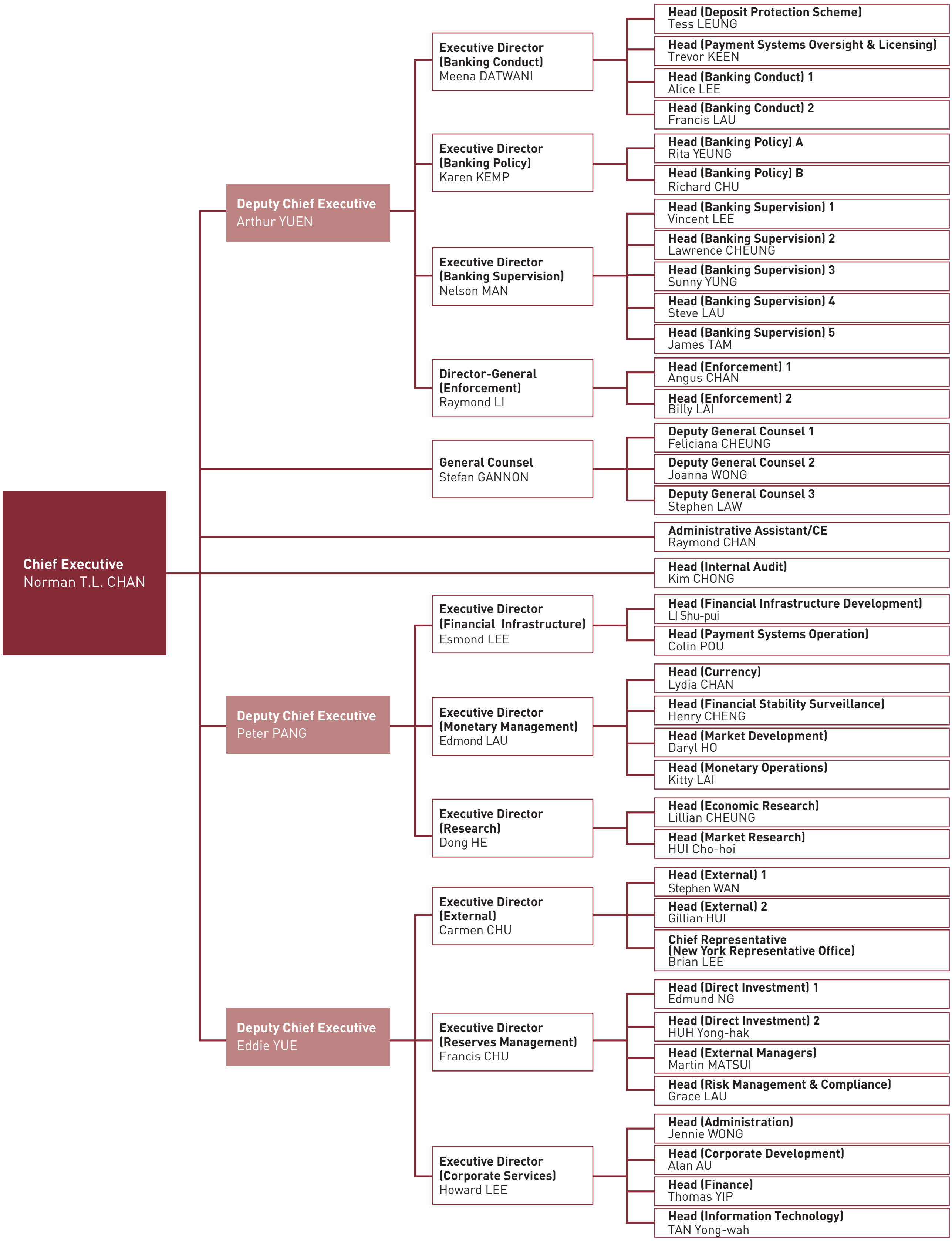
Carmen CHU, JP
Executive Director (External)

Howard LEE, JP
Executive Director (Corporate Services)

James H LAU Jr, JP
Chief Executive Officer
Hong Kong Mortgage Corporation

HKMA Organisation Chart

1 April 2012



Economic and Financial Environment

Hong Kong's growth momentum slowed in 2011 amid an increasingly austere global environment. In 2012, growth is expected to remain held back by the strong external headwinds, while inflationary pressures are likely to ease.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy moderated over the course of 2011 to grow by 5.0%, down from 7.0% in 2010 (Table 1 and Chart 1). The slowing growth reflected a slackening in the external sector amid an increasingly austere global environment. Domestic demand was remarkably resilient, underpinned by favourable labour market conditions. Inflationary pressures increased sharply in the first half of 2011 but were showing signs of tapering off towards the end of the year. The headline inflation rate reached a post-1997 high of 5.3% for the year. The stock market was subject to volatility throughout the year, while the residential property market has undergone some consolidation.

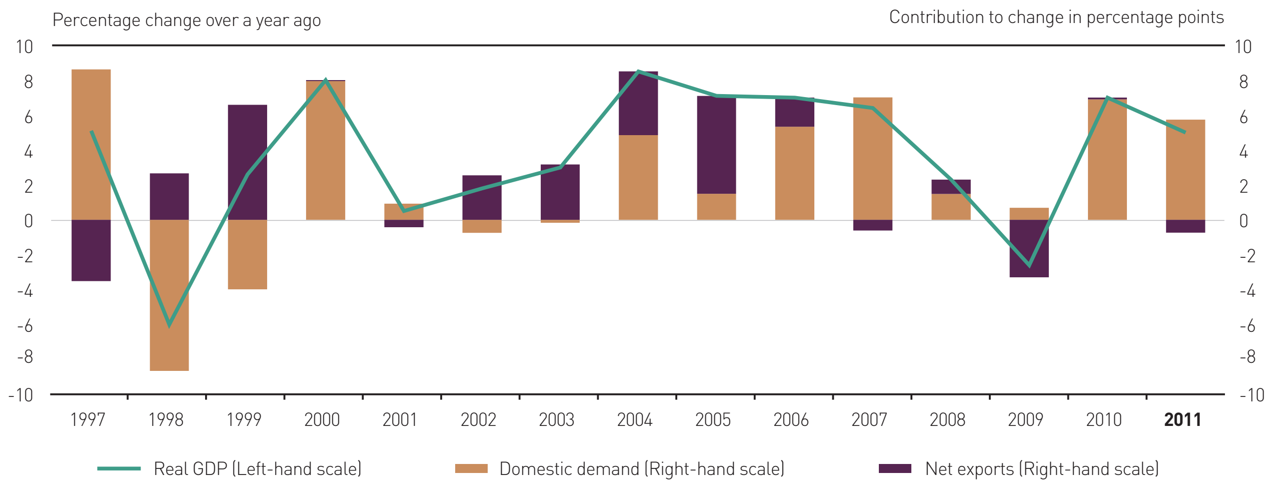
Monetary conditions remained loose in 2011, although there was some tightening in the second half of the year on a rise in the Hong Kong dollar effective exchange rate and interest rates. The Convertibility Undertakings were not triggered and the Aggregate Balance was virtually unchanged at a high level. Credit growth was strong, although the momentum slowed towards the end of the year. Growth in deposits, however, lagged behind the rises in loans, resulting in increases in loan-to-deposit ratios. Banks generally raised their effective deposit and lending interest rates, reflecting upward funding pressures.

Table 1 **Real GDP growth by expenditure component (period-over-period)**

(% Period-over-period, unless otherwise specified)	**2011**					2010				
	Q1	**Q2**	**Q3**	**Q4**	**2011**	Q1	Q2	Q3	Q4	2010
Gross Domestic Product	**3.0**	**-0.5**	**0.1**	**0.4**	**5.0**	1.9	1.9	0.9	1.7	7.0
(year-on-year growth)	**7.6**	**5.3**	**4.3**	**3.0**		8.0	6.8	6.9	6.6	
Private consumption expenditure	**0.6**	**3.1**	**2.1**	**1.0**	**8.6**	0.9	1.6	1.9	3.7	6.7
Government consumption expenditure	**1.7**	**-0.8**	**1.0**	**0.6**	**1.8**	1.0	0.8	0.8	-0.8	2.8
Exports										
Exports of goods	**10.1**	**-9.5**	**0.7**	**1.5**	**3.6**	4.1	4.7	2.2	-2.1	17.3
Exports of services	**3.5**	**0.6**	**0.1**	**-0.3**	**6.3**	3.8	2.1	2.4	0.7	14.6
Imports										
Imports of goods	**8.6**	**-5.1**	**-0.2**	**0.9**	**4.8**	5.7	3.4	0.1	-0.7	18.1
Imports of services	**-0.6**	**0.5**	**-0.4**	**3.4**	**3.1**	2.1	2.6	1.0	2.0	10.7
Overall trade balance (% of GDP)	**5.6**	**-3.0**	**7.5**	**4.2**	**3.7**	2.7	-1.1	12.5	6.8	5.4

Source: Census and Statistics Department.

Chart 1 **Real GDP growth by contribution**



Source: Census and Statistics Department.

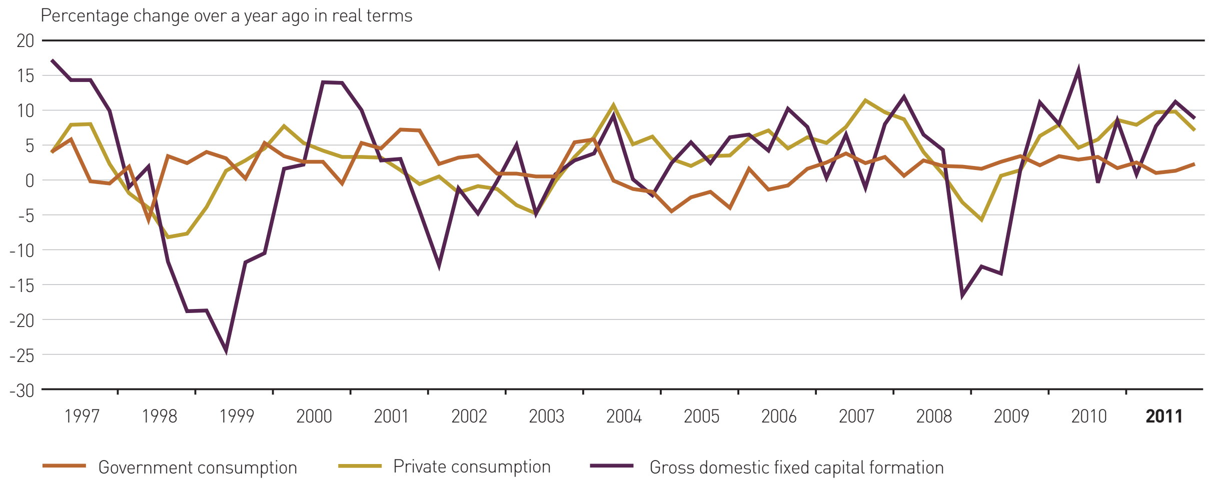
Domestic demand

Domestic demand increased strongly in 2011 (Chart 2). Private consumption grew at a remarkable 8.6%, underpinned by continued improvement in labour market conditions, rising household incomes and solid consumer confidence. Government consumption growth was steady at 1.8%. Overall fixed capital formation increased by 7.2%, with public infrastructure works and private capital spending taking the lead. Private-sector construction activities however remained on a downward trend. Inventory investment decreased slightly to become a drag on output growth.

External demand

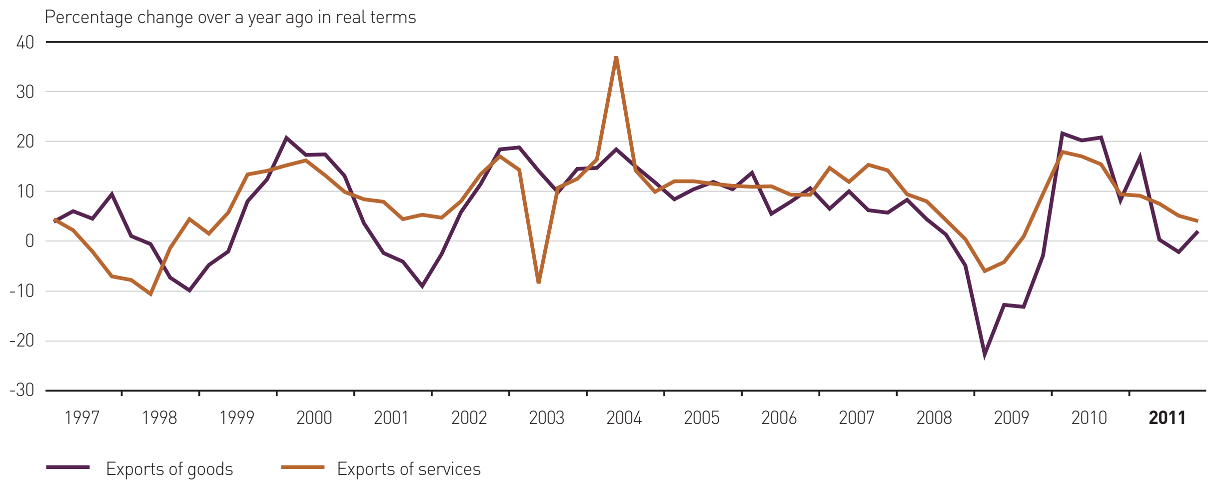
External trade performance slackened amid austere global conditions, in particular the deepening European sovereign debt crisis and sluggish recovery in the United States (Chart 3). Exports of goods increased by 3.6% in real terms in 2011, much weaker than the 17.3% rise in 2010. Exports to the US and other advanced markets faltered, while exports to Asian markets, including Mainland China, also slowed gradually. Exports of services were up 6.3% in real terms in 2011, following a 14.6% increase in 2010. Exports of travel services provided the main growth impetus, but exports of trade-related services and transportation

Chart 2 Domestic demand



Source: Census and Statistics Department.

Chart 3 Exports of goods and services



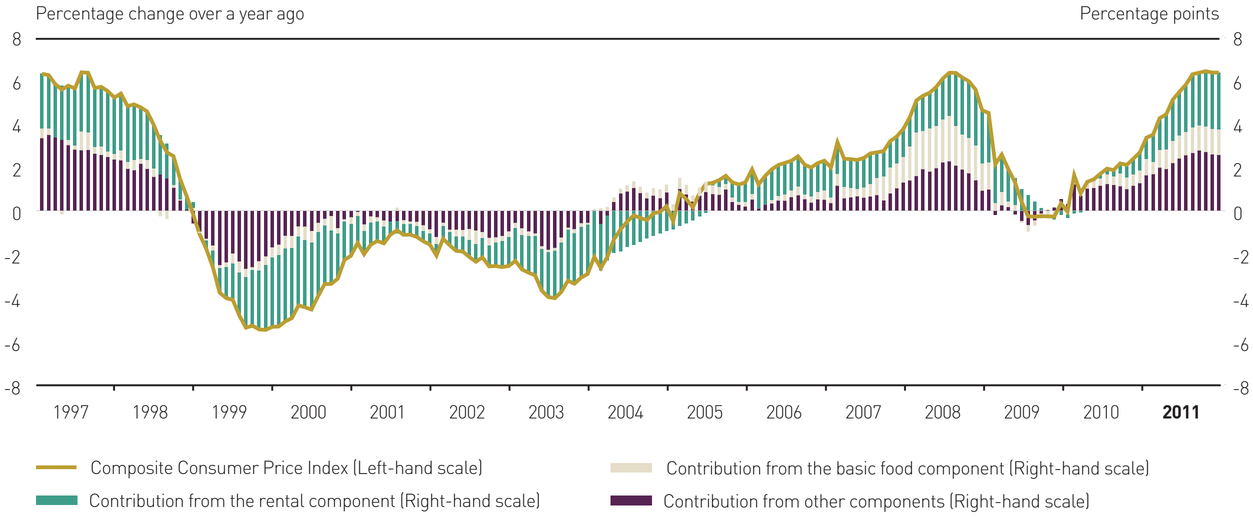
Source: Census and Statistics Department.

services, which are closely connected to merchandise trade, increased at a soft pace. Imports of goods and services rose by 4.8% and 3.1% in real terms respectively as domestic demand strengthened. Overall, net exports dragged down the output growth by 0.8 percentage points in 2011. In nominal terms, the trade surplus amounted to 3.7% of GDP, compared with 5.4% of GDP in 2010.

Inflation

Inflationary pressures increased considerably in 2011. Domestically, the earlier surge in private housing rentals continued to feed through to the housing component of the Consumer Price Index. Meanwhile, labour costs picked up due to a relatively tight labour market, while other non-tradable costs rose on the back of the solid economic growth. On the external front, increases in import prices remained elevated owing to the earlier surge in global food and commodity prices. For 2011 as a whole, the headline inflation rate reached 5.3%, compared with 2.4% in 2010. Netting out the effects of government relief measures, the underlying inflation rose to 5.3% from 1.7% a year earlier (Chart 4). However, towards the end of 2011, inflationary pressures showed incipient signs of tapering off amid a slowing in economic activity and a retreat in global food prices.

Chart 4 Consumer price inflation



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

Sources: Census and Statistics Department, and HKMA staff estimates.

Economic and Financial Environment

Labour market

The labour market showed broad-based improvements in 2011. Labour demand increased strongly, with job vacancies sustaining a rapid pace of increase, largely offsetting the pressure on labour demand brought about by the implementation of the statutory minimum wage. For the year, total employment rose by 2.9% to a record high, while the unemployment rate dropped to 3.4%, the lowest level since 1997 (Chart 5). In tandem with the relatively tight labour market, wages and earnings rose noticeably across major sectors and occupation categories. Labour earnings rose by 7.9% in nominal terms and 2.5% in real terms. Such increases were more noticeable in the lower decile group, in part due to the additional boost from the statutory minimum wage.

Stock market

The Hong Kong stock market experienced a great deal of volatility throughout 2011, reflecting the jittery global investor sentiment. The Hang Seng Index dropped 20.0% to close the year at 18,434 (Chart 6). The downbeat performance was broadly in line with movements in the major European and emerging Asian markets in US dollar terms. The average daily turnover of the stock market remained virtually unchanged from 2010 at

Chart 5 Unemployment rate

Source: Census and Statistics Department.

Chart 6 Asset prices

Sources: Rating and Valuation Department, and CEIC.

$70.0 billion, but there was a sharp increase in short-selling turnover. Total capital raised through new share floatation and post-listing arrangements decreased by 42.9% to $490.4 billion in 2011.

Property market

The residential property market remained relatively buoyant in the first half of 2011 but cooled down thereafter, reflecting the combined impact of the multiple rounds of stabilising policy measures, a weaker global growth outlook and rising mortgage interest rates. For 2011 as a whole, housing prices rose by 10.9%, despite a 3.9% decline in the period between June and December. Trading activities became increasingly sluggish, falling by 37.8% in 2011 in terms of transaction agreements lodged with the Land Registry. Confirmor transactions and flipping trade dropped notably after the introduction of the Special Stamp Duty in late 2010. New mortgage lending rose in the first half of 2011 but shrank dramatically in the second half. Meanwhile, credit conditions for mortgage lending gradually tightened as mortgage interest rates rose and loan-to-value ratios fell.

OUTLOOK FOR THE ECONOMY

Economic environment

Economic activity is expected to slow visibly in 2012. The stiff headwinds from the external environment – owing to sluggish growth prospects in advanced economies, an unresolved European sovereign debt crisis and the ensuing global market volatilities – will in all likelihood remain a significant drag on Hong Kong's exports. Domestic demand in Hong Kong, mainly driven by private consumption, is expected to provide some cushion against the potential setback in exports. Overall, the Hong Kong economy is expected to expand at a below-trend rate in 2012. Most private sector analysts are currently projecting the economy to grow by 1.6 - 3.9%, averaging at around 3.0%.

Inflation and the labour market

Inflationary pressures are expected to recede in 2012, largely due to the likely slowdown in growth and closing of the positive output gap. Upward pressures from basic food prices and private housing rentals will also likely lessen, albeit remaining significant. Private sector analysts now expect the headline inflation rate to ease to 4.3% in 2012. Meanwhile, labour market conditions will likely become less favourable. Corporate hiring activity is expected to slow amid weaker economic prospects. A number of corporate surveys have already indicated a softening in hiring intentions. Private sector analysts project the unemployment rate to rise gradually to 3.6% by the end of 2012.

Uncertainties and risks

The outlook for 2012 is subject to considerable downside risks, in particular how the European sovereign debt crisis will evolve and whether the euro-zone policymakers can defuse the problems. In the event that the policymakers in the euro zone fail to formulate a decisive and sustainable resolution, causing the debt crisis to degenerate into a full-blown global financial crisis, contagion through the financial channels could knock the global and Hong Kong economy into a much more severe downturn than is expected. At the same time, the continued risks of a double-dip recession in the major advanced economies and of a sharper-than-expected slowdown in the Mainland China economy could heavily weigh on Hong Kong's economic performance.

Risks to the inflation outlook appear to be broadly balanced. Inflationary pressures could ease back further than expected should the economy fall into a deeper downturn. On the other hand, another bout of large-scale monetary easing by the central banks in the major advanced economies could fuel a resurgence in global commodity price pressures, which would translate into higher cost-push inflation in Hong Kong.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained robust in 2011 despite a worsening of the European sovereign debt crisis. Bank lending continued to grow significantly, resulting in tightened liquidity conditions, but the liquidity ratio of banks remained well above the statutory minimum. Asset quality improved further and locally incorporated AIs remained well capitalised.

Interest rate trends

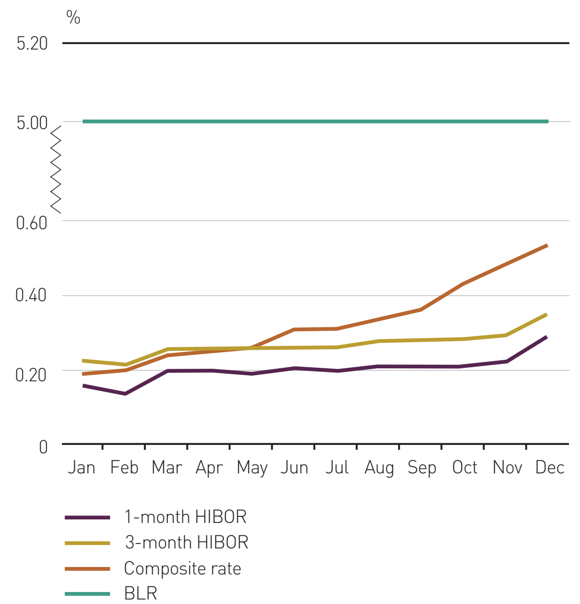
The accommodative monetary policies adopted by central banks in major developed economies extended into 2011. In line with the US dollar rates, Hong Kong dollar interbank interest rates remained low throughout the year. However, the composite interest rate, which reflects the average cost of funds of retail banks, trended higher as retail banks offered higher interest rates to attract customer deposits partly in response to tighter liquidity (Chart 7).

Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 18.0% in 2011. As their balance sheets grew briskly during the year, the post-tax return on average assets of retail banks remained stable at 1.01% in 2011 compared with 2010 (Chart 8). Increases in both interest and non-interest incomes contributed to the profit growth.

The net interest margin (NIM) of retail banks narrowed further in 2011 to a yearly average of 1.25% compared with 1.32% in 2010 (Chart 9), mainly due to persistently low interest rates and the competitive lending environment. In view of tighter liquidity, banks started to adjust their pricing strategies more notably in the second half of 2011 by raising loan spreads, such as for residential mortgage lending, and interest rates paid on customer deposits. This resulted in a mild rebound in the annualised NIM in the fourth quarter of 2011 to 1.29%, from 1.19% in the second quarter. For 2011 as a whole, the net interest income of retail banks rose by 11.1%, as the contribution from credit growth more than offset the reduction in NIM.

Chart 7 HIBORs, composite rate and BLR

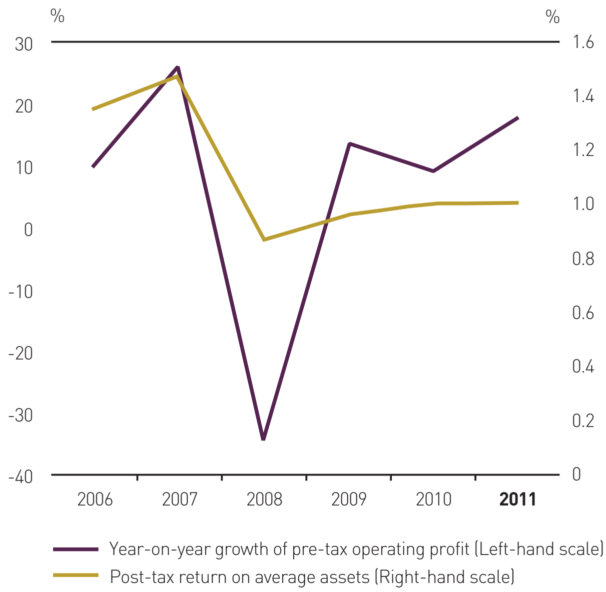


Notes:

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

2 HIBORs are monthly averages.

Chart 8 Retail banks' performance



Due to strong revenue growth from foreign exchange operations and from fees and commissions, non-interest income of retail banks increased by 9.1% in 2011. With faster growth in net-interest income, the proportion of non-interest income to total income of retail banks slightly reduced to 47.6% from 48.1% in 2010.

The increase in staff and rental expenses more than offset a recovery of Lehman-related expenses incurred previously and drove up the operating costs of retail banks by 3.2% in 2011. However, the cost-to-income ratio was down to 46.8% from 49.9% in 2010 due to the stronger growth in operating income in the period (Chart 10).

Net charge for debt provisions rose to $2.7 billion in 2011 from $1.8 billion in 2010.

Chart 9 **Retail banks' net interest margin**

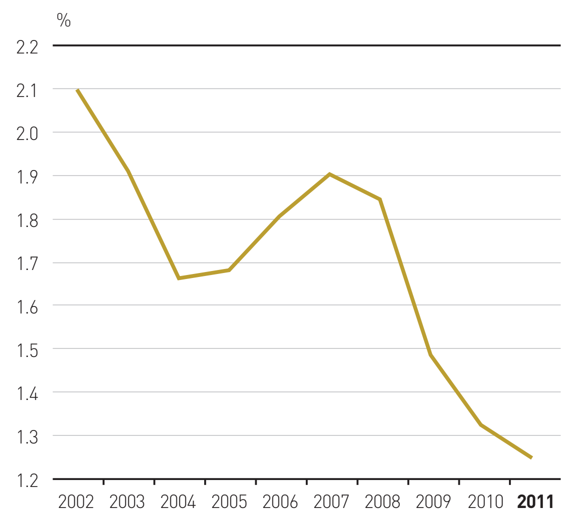
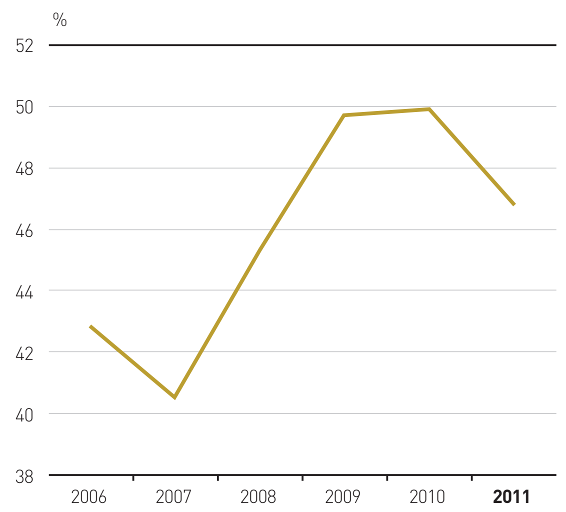


Chart 10 **Retail banks' cost-to-income ratio**



Asset quality

The asset quality of retail banks remained sound in 2011. With a significant growth in bank lending during the period, the classified loan ratio fell to 0.59% at the end of 2011 from 0.77% at the end of 2010 (Chart 11). The combined ratio of overdue and rescheduled loans was also lower at 0.49% compared with 0.60% at the end of 2010.

The quality of surveyed institutions' residential mortgage lending remained solid. The delinquency ratio was unchanged at 0.01% at the end of 2011 (Chart 12). The rescheduled loan ratio edged down to 0.02% from 0.04% in 2010. Although the outstanding number of residential mortgage loans in negative equity rebounded to 1,465 at the end of 2011 from 118 a year earlier, it was lower than the recent peak recorded in December 2008 (10,949). The vast majority of these cases were related to mortgage loans with loan-to-value ratio at 90% or above, including staff housing loans and home loans under the Mortgage Insurance Programme.

The quality of credit card portfolios improved slightly, with the delinquency ratio declining to 0.19% at the end of 2011 from 0.20% in 2010 (Chart 12). Similarly, the combined delinquent and rescheduled ratio declined to 0.25% from 0.28% last year and the charge-off ratio fell to 1.49% from 1.91% in 2010.

Balance sheet trends

Total loans and advances of retail banks grew by 14.3% in 2011, while total deposits rose by 9.1%. The overall loan-to-deposit ratio of retail banks increased to 55.3% from 52.8% in 2010. The Hong Kong dollar loan-to-deposit ratio also rose to 76.2% from 70.5% in 2010 (Chart 13).

Chart 11 Asset quality of retail banks

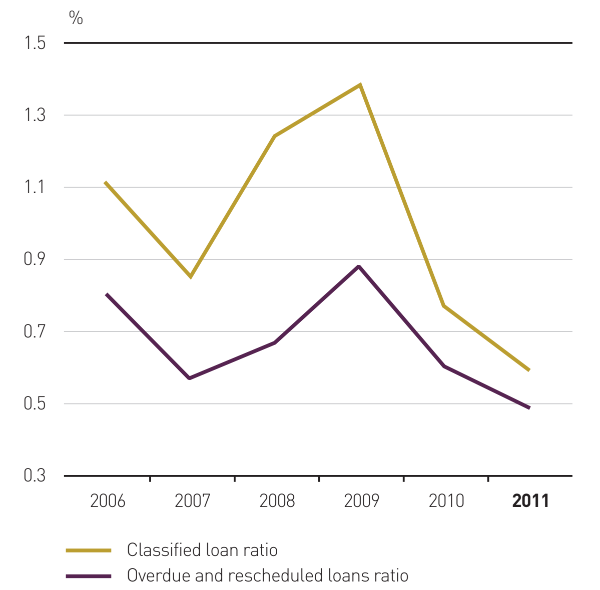
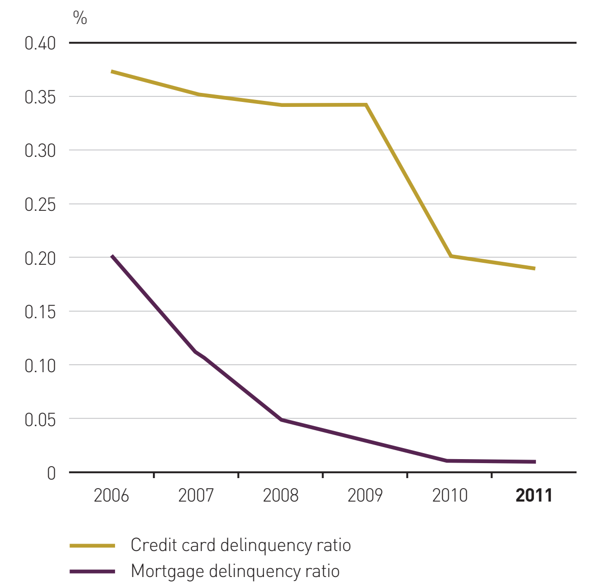


Chart 12 Delinquency ratios of residential mortgages and credit card lending of surveyed institutions

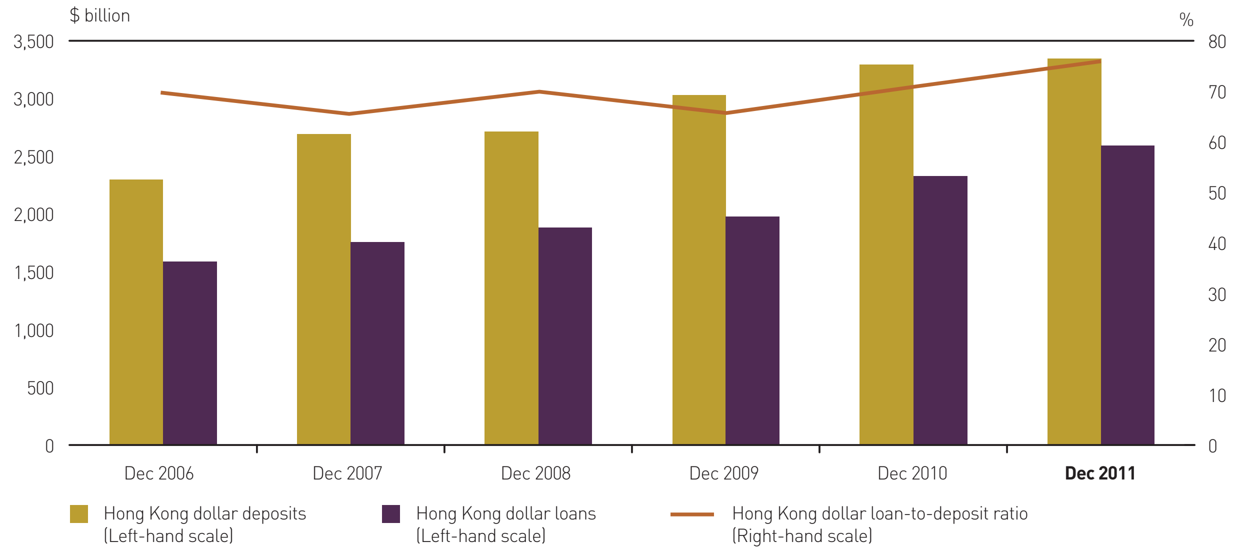


While credit growth had moderated since 2011, the overall pace of growth for one year as a whole was still fast. The growth in loans for use outside Hong Kong and trade financing outpaced that in loans for use in Hong Kong. The increase in domestic lending was broad-based with particularly strong growth observed in lending to wholesale and retail sectors.

The continued strong credit growth with milder increase in customer deposits exerted pressure on the liquidity of the banking sector, as reflected in the rising loan-to-deposit ratios. Amid heightened uncertainties of the external environment, the HKMA took a series of supervisory measures to ensure the resilience of the banking sector against potential stress on banks' liquidity and credit risks.

Retail banks' total non-bank China exposures[1] rose to $1,573 billion at the end of 2011 from $1,158 billion in 2010. For the banking sector as a whole, non-bank China exposures increased to $2,318 billion from $1,630 billion in 2010.

Chart 13 Retail banks' Hong Kong dollar loans and deposits



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

Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit increased by 3.1% in 2011. Compounded by the strong loan growth, the share of total holdings of NDIs relative to total assets reduced to 24% at the end of 2011 from about 26% a year ago. Among the holdings of NDIs, 47% were government-issued (42% in 2010), 31% were issued by non-bank corporates (36% in 2010), and 22% were issued by banks (22% in 2010) (Chart 14).

Chart 14 **Retail banks' holdings of negotiable debt instruments at the end of 2011 (counterparty breakdown)**

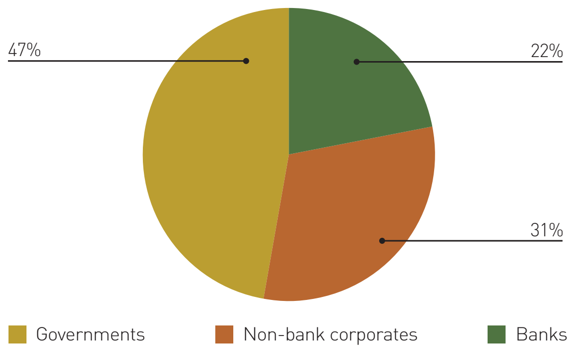
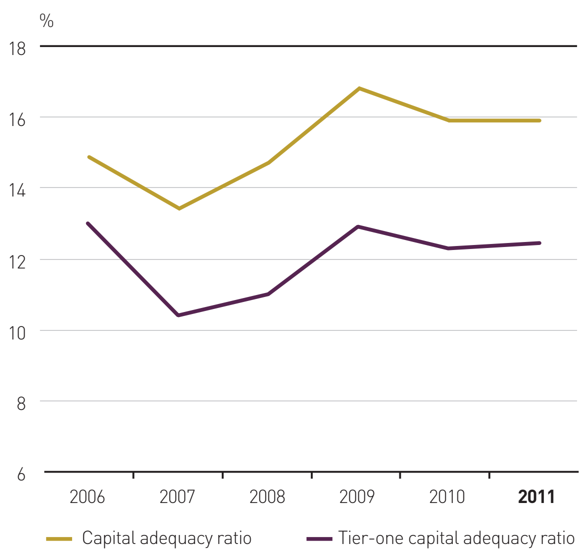


Chart 15 **Consolidated capital adequacy ratio of locally incorporated AIs**

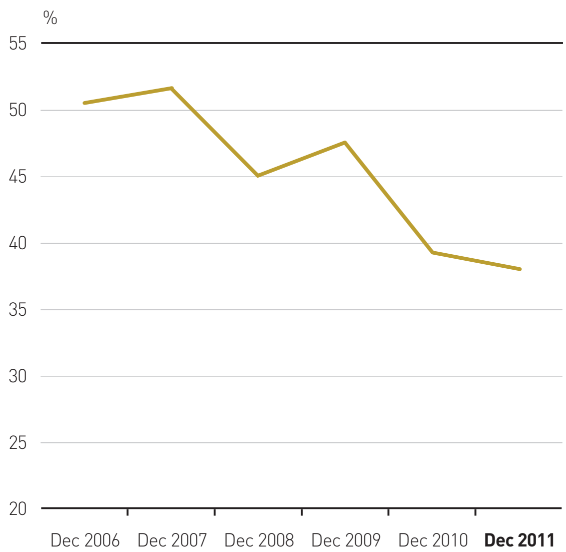


Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. The consolidated capital adequacy ratio of all locally incorporated AIs was 15.8% at the end of 2011, well above the statutory minimum of 8% (Chart 15). The Tier-1 capital adequacy ratio edged up to 12.4% at the end of 2011 from 12.2% a year earlier as a few banks strengthened their capital positions by raising share capital during the period.

With a larger loan book, which is usually less liquid than debt securities and bank placements, the average liquidity ratio of retail banks declined to 38.0% in the final quarter of 2011 from 39.3% in the same quarter in 2010, but remained well above the statutory minimum of 25% (Chart 16).

Chart 16 **Retail banks' liquidity ratio (quarterly average)**



PROSPECTS FOR 2012

The operating environment for banks will continue to be challenging in 2012 in view of heightened uncertainties in the external environment which will affect the domestic economy. Volatility in financial markets has also increased markedly. Against this background, banks must continue to be vigilant towards possible contagion from the European sovereign debt crisis on the Hong Kong banking system and the risk of a sudden outflow of funds. At the same time, it is important to monitor closely the latent systemic impact of continuing rapid credit expansion, and whether the unusually low interest margin environment in Hong Kong may provide incentives for excessive risk taking by banks. In this environment banks should be extra prudent in managing their credit, funding and other risks, including by maintaining robust levels of capital and liquidity.

Monetary Stability

Despite a turbulent macro-financial environment, the Hong Kong dollar exchange rate remained stable against the US dollar. Activities in Hong Kong's money market were orderly, with a slight upward adjustment in the interest rates. The Hong Kong Government is fully committed to maintaining the Linked Exchange Rate system.

OBJECTIVES

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

The Monetary Base (Table 1) comprises:

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

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism and the firm commitment by the HKMA to honour the Convertibility Undertakings (CUs). When the demand for the Hong Kong dollar is greater than the supply and the market exchange rate strengthens to the strong-side CU of HK$7.75 to the US dollar, the HKMA stands ready to sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then expand to push down Hong Kong dollar interest rates, creating monetary conditions that move the Hong Kong dollar away from the strong-side limit to within the Convertibility Zone of 7.75 to 7.85. Conversely, if the supply of the Hong Kong dollar is greater than demand and the market exchange rate weakens to the weak-side CU of HK$7.85 to the US dollar, the HKMA will buy Hong Kong dollars from banks. The Aggregate Balance will then contract to drive Hong Kong dollar interest rates up, pushing the Hong Kong dollar away from the weak-side limit to stay within the Convertibility Zone.

Table 1 Monetary Base

$ million	**31 December 2011**	31 December 2010
Certificates of Indebtedness[1]	**259,815**	226,705
Government-issued currency notes and coins in circulation[1]	**9,930**	8,929
Balance of the banking system	**148,684**	148,702
Exchange Fund Bills and Notes (EFBN) issued[2]	**658,748**	655,220
Total	**1,077,177**	1,039,556

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

2 The amount of EFBN shown here is different from that in the balance sheet of the Exchange Fund in this Annual Report. In accordance with the accounting principles generally accepted in Hong Kong, the EFBN held by the HKMA on behalf of the Exchange Fund in relation to its trading of the EFBN in the secondary market are offset against the EFBN issued, and the net amount is recorded in the balance sheet.

Monetary Stability

REVIEW OF 2011

Exchange-rate stability

Currency stability in Hong Kong was sustained during the year (Chart 1). Between January and March, the market exchange rate softened slightly from around 7.77 to 7.80, partly reflecting the repatriation of funds raised in the equity market. With the US dollar depreciating against other major currencies, the Hong Kong dollar exchange rate strengthened somewhat against the US dollar in April. From May to July the bilateral exchange rate weakened again as growing worries about the European sovereign debt problems weighed on market sentiment. In the five months to December, the exchange rate largely mirrored the swings in the US dollar against other major currencies, either strengthening amid a weaker US dollar or weakening alongside a stronger US dollar. Overall, the market exchange rate traded within a narrow range between 7.7671 and 7.8097 during the year.

Activities in the local foreign exchange market were orderly throughout the year. The convertibility rates were not triggered and the HKMA did not carry out any discretionary foreign exchange operations. Notably, the foreign exchange market continued to function smoothly despite a series of external turbulences, including the political unrest in the Middle East and North Africa, the natural disasters and nuclear crisis in Japan, the downgrade of the US sovereign credit rating by the Standard & Poor's, the escalation of the European sovereign debt crisis and increased volatility in global equity markets.

Chart 1 Market exchange rate in 2011

Money market

After being largely stable at low levels in the first half of the year, Hong Kong dollar interbank interest rates increased slightly in the second half, tracking the upward movements in their US dollar counterparts (Chart 2). The upticks in HIBORs also reflected increased demand for year-end Hong Kong dollar liquidity and occasional funding needs arising from initial public offerings in the equity market. Despite the modest rises, most short-term interbank rates stayed well below the Base Rate of the Discount Window.

Tighter Hong Kong dollar liquidity towards the end of the year was also evident in the forward market. Following some widening in August, the Hong Kong dollar forward discounts broadly narrowed between September and December and the three-month forward point even momentarily turned from discounts to small premiums in December (Chart 3).[1] Some market participants might have tapped into collateralised term funding by swapping US dollars for Hong Kong dollars, leading to the contraction in forward discounts, especially during the last two months of the year. From January to July the forward discounts were generally stable, consistent with the roughly stable HIBOR-LIBOR spreads.

Chart 2 Hong Kong dollar interest rates in 2011

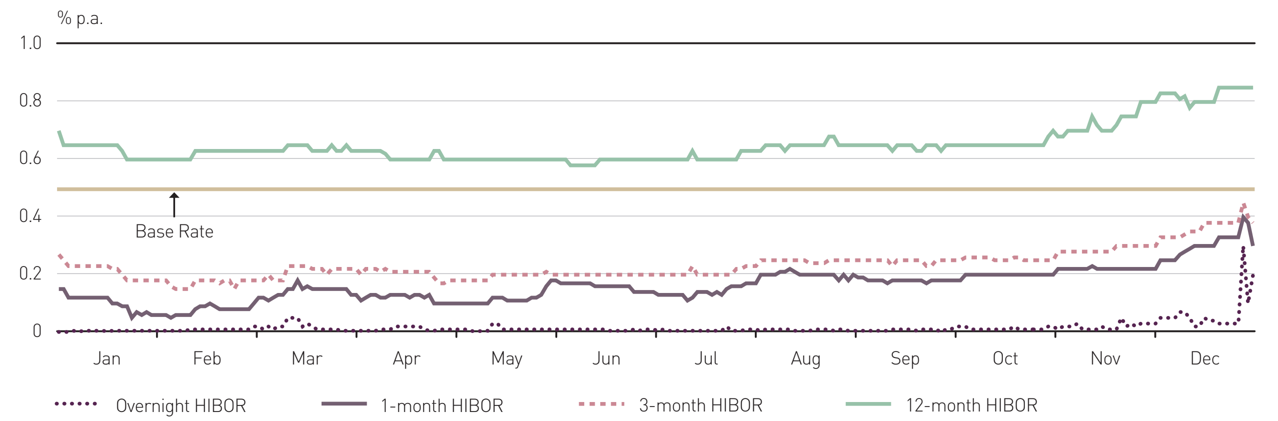


Chart 3 Hong Kong dollar forward points in 2011

1 The widening forward discounts in August were reportedly driven by precautionary demand for US dollar liquidity amid concerns about the spill-over effect of euro area bank funding pressures.

The Linked Exchange Rate system

Against the backdrop of rising inflationary pressures and the downgrade of the US sovereign credit rating, there was renewed discussion among commentators in mid year about the appropriateness of the Linked Exchange Rate system (LERS). The Hong Kong Special Administrative Region Government has reiterated its full commitment to the LERS.[2] In its annual Article IV consultation with Hong Kong, the International Monetary Fund also gave a strong endorsement of the LERS and our policy framework for safeguarding monetary and financial stability.

While short-term HIBORs, by design of the Currency Board system, follow the short-term US dollar LIBORs very closely, longer-term and retail interest rates in Hong Kong may differ to various degrees from their US dollar counterparts, depending on domestic supply and demand factors. In fact, Hong Kong banks gradually tightened their mortgage interest rates for newly approved loans despite the stable HIBORs in the first half of the year, and raised Hong Kong dollar deposit interest rates to attract new deposits. As such, the HKMA has reminded the public to manage the risk of higher interest rates carefully, and has promoted continued prudent risk management by banks so that Hong Kong will be able to cope well with any adverse shocks. In this context, the HKMA has introduced multiple rounds of prudential measures on residential mortgage loans (with the latest one on 10 June) and has continued to be vigilant against excessive credit growth.

Over the years, the operating framework of the LERS has become stronger and more transparent. To improve the transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998. The Backing Ratio (defined as the Backing Assets divided by the Monetary Base) moved around 108 - 109% during the year and closed at 108.92% on 31 December (Chart 4). Under the LERS, while specific Exchange Fund assets have been designated for the Backing Portfolio, all Exchange Fund assets are available to support the Hong Kong dollar exchange rate. The large amount of financial resources under the Exchange Fund will provide a powerful backstop in the event of a crisis, protecting Hong Kong's monetary and financial stability.

Chart 4 Daily movement of the Backing Ratio in 2011

[2] The Financial Secretary stated in his blog on 14 August that the LERS continued to be the most appropriate exchange rate arrangement for Hong Kong. See also the *inSight* article of 15 August by the Chief Executive of the HKMA on the LERS.

Macro-prudential surveillance

In December 2011 the Financial Stability Surveillance Division was established under the Monetary Management Department to strengthen the HKMA's oversight of global financial issues. The new Division brings together staff of the Banking Policy Department and the Monetary Operations Division previously engaged in macro-prudential surveillance work. Their analyses will form the basis for deliberations by the Macro Surveillance Committee, which was set up in the second quarter of the year to facilitate regular monitoring of risks and vulnerabilities to Hong Kong's monetary and financial system. The Committee is chaired by the Chief Executive of the HKMA and includes the three Deputy Chief Executives and other senior executives. The functions of the Committee are to:

- identify potential risks and threats to the monetary and financial system in Hong Kong and discuss possible measures to address such risks
- review existing measures for managing risks in the monetary and financial system to identify possible gaps and ensure the adequacy of these measures
- encourage cross-department sharing of relevant information on macro surveillance with a view to enhancing macro surveillance capability of the HKMA.

In 2011 the Committee examined a number of major risks, including the rapid pace of credit growth among authorized institutions and the development of the European sovereign debt crisis.

Other activities

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2011, the Sub-Committee considered issues including the effects of the loan-to-deposit ratio of the Hong Kong banking sector on domestic interest rates; chances of a hard landing of the Mainland economy and interaction between onshore and offshore Eurodollar markets. Records of the Sub-Committee's discussions on these issues and the reports on Currency Board operations submitted to the Sub-Committee are published on the HKMA website.

The Hong Kong Institute for Monetary Research continued to sponsor research in the fields of monetary policy, banking and finance. In 2011, the Institute hosted 22 research fellows and one post-doctoral fellow. It also published 41 working papers and two occasional papers.

The Institute organised eight international conferences and workshops, including the following main ones. In January, the Institute held its Second Annual International Conference on the Chinese Economy with the theme "Macroeconomic Management in China: Monetary and Financial Stability Issues". This conference covered a wide range of issues such as China's inflation, implementation of monetary policy, rising wages, housing market conditions, export growth and Asian business cycle synchronisation. In October, the Institute, together with the Asia and Pacific Department of the International Monetary Fund, held the "Monetary and Financial Stability in the Asia-Pacific amid an Uneven Global Recovery" conference, which dealt with a number of empirical and policy issues related to the monetary and financial stability in the region. The Institute also organised its Ninth Annual Summer Workshop on "US Monetary Policy and Asset Bubbles in Hong Kong", and its Ninth Conference on the Mainland economy with the theme "Money and Bond Market Developments in Mainland China". These conferences and workshops were attended by participants from academia, the financial services industry and central banks around the world. In addition, the Institute organised 36 public seminars during the year covering a broad range of economic and monetary issues.

Monetary Stability

Notes and coins

At the end of 2011, the total value of banknotes in circulation was $259.8 billion, an increase of 14.6% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to $9.7 billion, up 11.5% (Charts 8 and 9). The value of $10 notes in circulation issued by the Government (both paper and polymer notes) reached $3.7 billion, an increase of 24.9% from 2010.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2011

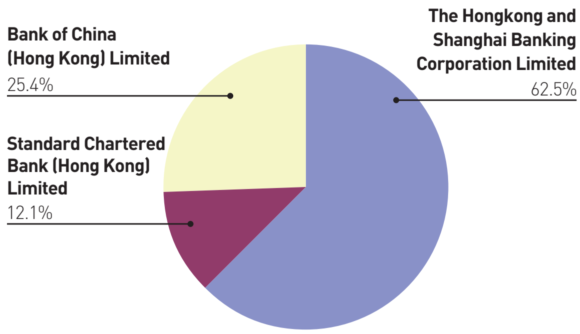
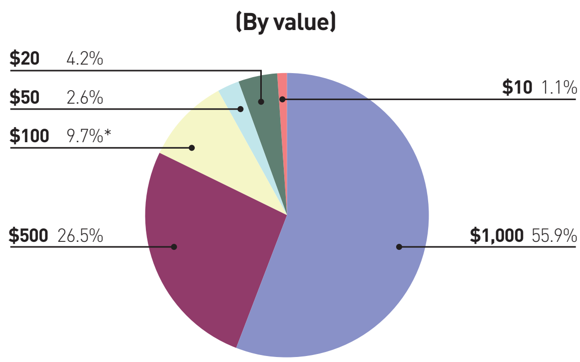
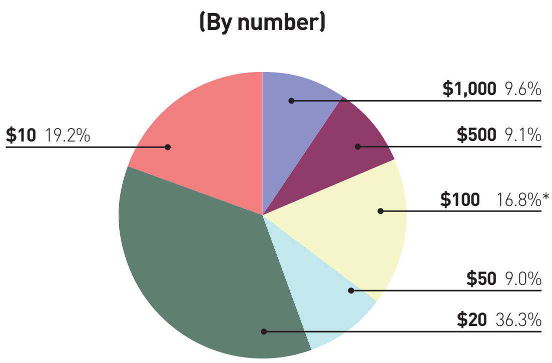


Chart 6 Distribution of banknotes in circulation at the end of 2011





* Includes 0.1 percentage points contributed by $150 banknote.

Chart 7 Banknotes in circulation at the end of 2011

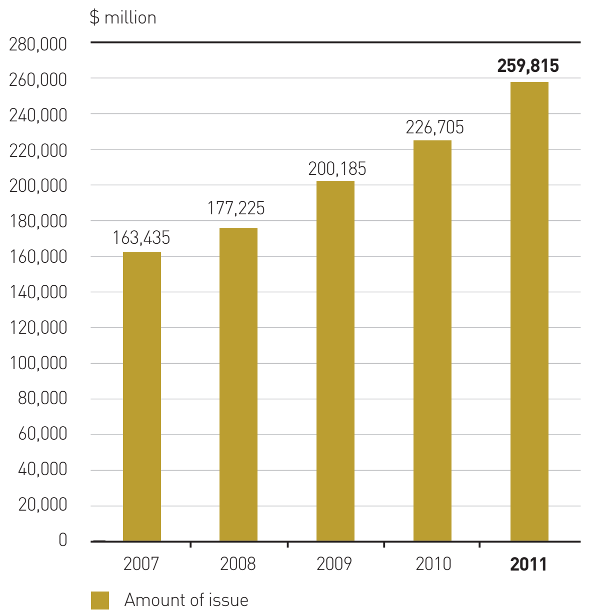


Chart 8 Government-issued notes and coins in circulation at the end of 2011

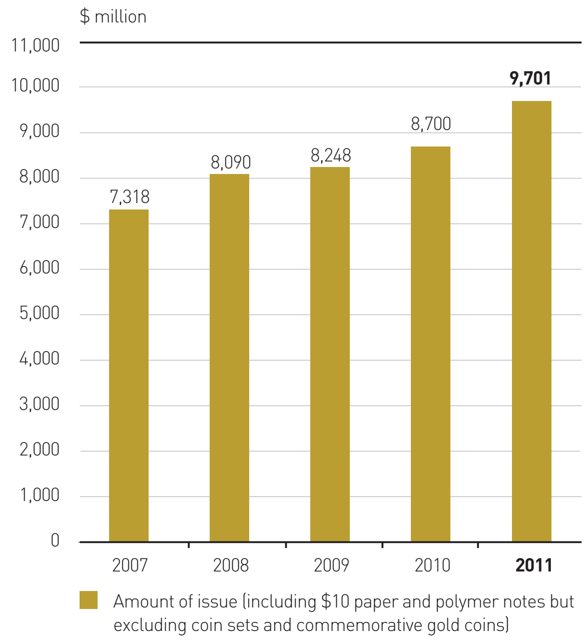
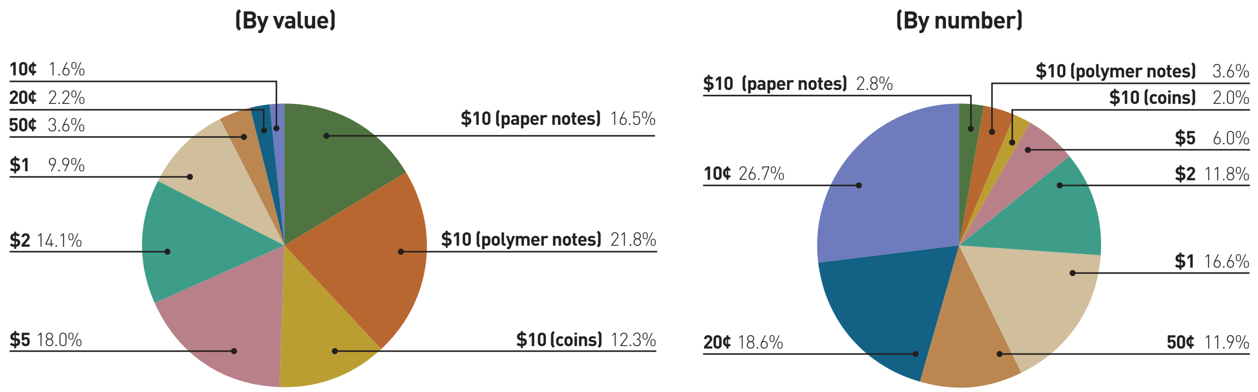


Chart 9 Government-issued notes and coins in circulation at the end of 2011



2010 series Hong Kong banknotes

Following the circulation of the 2010 series new $1,000 and $500 banknotes, the HKMA and the three note-issuing banks unveiled the designs of the remaining $100, $50 and $20 banknotes in July 2011. These new banknotes incorporate the same state-of-the-art security features as the new $1,000 and $500 banknotes. They also carry the same special features to help the visually impaired differentiate the denominations. All five denominations of the 2010 series banknotes have been put into circulation since January 2012.

The HKMA has launched an extensive educational campaign to promote public awareness of the new banknotes. A total of 37 seminars were conducted during the year for over 6,000 participants, including bank tellers, retailers, teachers and students, and roving exhibitions were held in six districts to introduce the new banknotes to the public.

The public visits a roving exhibition on the new banknotes.

$10 polymer note

About 211 million polymer notes were in circulation at the end of 2011, representing 57% of the $10 notes issued by the Government.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with 12 million coins removed from circulation in 2011.

Exchange Fund Bills and Notes

In June the HKMA enhanced the market-making arrangements by refining the selection criteria for Eligible Market Makers of EFBN to include a broader range of quantitative indicators, such as turnover by reference to the outstanding EFBN, market-making activities through the electronic trading platform, aggregate positions in EFBN and bid-ask spreads in quotations. At the same time, the HKMA ceased publishing the League Tables on turnover of EFBN.

By the end of 2011, the amount of outstanding Exchange Fund paper stood at $655 billion (Table 2). During the year, the HKMA continued to fine-tune the maturity mix of the EFBN with increased issuance of 10- and 15-year Exchange Fund Notes.

PLANS FOR 2012 AND BEYOND

The external macro-financial environment is likely to remain highly challenging in 2012. The European sovereign debt crisis remains unresolved and risks to global financial stability have increased substantially. The uncertain economic outlook and increased volatility in local financial markets will pose risks to Hong Kong's monetary and financial stability. The HKMA will remain vigilant and prudent and stand ready to deploy appropriate measures as necessary to protect monetary and financial stability in Hong Kong. Research programme for the coming year will continue to study issues affecting the economy and assess potential risks to Hong Kong's monetary and financial stability. The EFAC Currency Board Sub-Committee will continue to examine issues relevant to Hong Kong's monetary and financial stability, review the technical aspects of the Currency Board arrangements and, where appropriate, recommend measures to strengthen them.

Table 2 Outstanding issues of Exchange Fund Bills and Notes

$ million	2011	2010
Exchange Fund Bills (by original maturity)		
28 days	**600**	0
91 days	**348,313**	346,038
182 days	**195,000**	195,000
364 days	**42,200**	42,200
Sub-total	**586,113**	583,238
Exchange Fund Notes (by remaining tenor)		
1 year or below	**17,000**	17,000
Over 1 year and up to 3 years	**28,000**	29,200
Over 3 years and up to 5 years	**10,900**	11,500
Over 5 years and up to 10 years	**8,000**	8,000
Over 10 years	**5,400**	4,200
Sub-total	**69,300**	69,900
Total	**655,413**	653,138

Banking Stability

The HKMA maintained its supervisory focus on authorized institutions' management of liquidity and credit risks and Mainland China-related business as risks of spill-over from the European sovereign debt crisis persisted, and credit growth continued at a fast, although moderating, pace. A further round of countercyclical measures was applied to mortgage lending to mitigate the risk that rising property prices could affect the stability of the banking sector. Further steps were taken to strengthen investor and consumer protection.

REVIEW OF 2011

Risk-based supervision

The European sovereign debt crisis led to volatile financial-market conditions in 2011. The rapid credit growth and expansion of Mainland operations by authorized institutions (AIs) continued, albeit at a slightly slower pace than previously. In view of these factors, the HKMA maintained its supervisory focus on AIs' management of liquidity and credit risks; funding strategy; Mainland-related business (including renminbi business); and other emerging areas of concern.

During the year the HKMA carried out 198 on-site examinations, while resources were re-allocated to more frequent meetings with senior management and the heads of risk management of individual AIs to address emerging prudential concerns, including the potential threats to risk management arising from the fast pace of credit growth and the European sovereign debt crisis. Stress tests conducted by the HKMA internally were strengthened to assess the capital and liquidity positions of retail banks, detect possible vulnerabilities under severe but plausible scenarios, and formulate corrective actions.

The HKMA did not receive any new applications from AIs to use the internal ratings-based (IRB) approach for credit risk calculation. The number of IRB reviews declined as a result to four (from 10 in 2010), focusing on changes to previously-approved IRB models. Five on-site examinations were also conducted on AIs using the internal models (IMM) approach for market risk calculation, mainly driven by the implementation of enhanced market risk capital framework in line with the requirements set by the Basel Committee on Banking Supervision. The HKMA also conducted examinations on the internal capital adequacy assessment process (CAAP) of eight AIs which have substantially established CAAPs.

The specialist teams conducted on-site examinations on market risk management and treasury activities of seven AIs and assessed six AIs' firm-wide stress testing and liquidity risk management. The specialist teams also performed 30 on-site examinations on AIs' sale of investment and insurance products, and other areas relating to their securities business, following a pick-up in business volume during the year. In July on-site examinations of AIs' compliance with the Deposit Protection Scheme Representation Rules for 2011 commenced. Seven such examinations were completed by the end of the year and the remainder will continue in 2012. Other areas examined by the specialist teams included anti-money-laundering (AML) and counter-terrorist-financing (CFT) controls as well as technology and operational risk management. In addition, a round of thematic examinations was conducted to assess 10 AIs' progress in the implementation of the HKMA's "Guideline on a Sound Remuneration System".

The HKMA's supervisory teams conducted 193 off-site reviews of AIs' financial positions and business operations. Other regular supervisory activities included analysis of prudential returns, review of AIs' new business initiatives and dealing with incidents of regulatory non-compliance. The supervisory teams met the boards or members of board-level committees of eight AIs and held a tripartite meeting with the management and external auditors of one AI. The reduction in tripartite meetings was mainly because meetings with senior management and board-level committees of AIs had already covered issues normally discussed in such meetings. The Banking Supervision Review Committee considered 10 cases relating to authorization of AIs in 2011. Details of the operational supervisory work performed in 2011 are set out in Table 1.

During the year the HKMA commissioned four reports under section 59(2) of the Banking Ordinance requiring four AIs to appoint external auditors to review internal control issues and report their findings to the HKMA. One of these reports concerned systems of compliance, risk management controls and incident-escalation mechanisms. Another covered the accuracy of documentation provided to investors in relation to the issuance of structured products. The other two reports covered AML/CFT controls.

No AI breached the requirements of the Banking Ordinance relating to the capital adequacy ratio or liquidity ratio in 2011. There was one breach of the approval requirement under section 44(1) relating to the establishment of a local branch, three under section 71D on the appointments of Executive Officers, two under section 74(1) on the appointment of Chief Executives and one under section 87A on the acquisition of share capital in companies. All of the breaches were assessed to be unintentional. They were rectified promptly by the relevant AIs and did not affect the interests of depositors.

Table 1 Operational supervision

		2011	2010
1	On-site examinations	**198**	216
	Regular examinations	**39**	69
	– risk-based	**30**	49
	– overseas	**9**	20
	Basel II – Reviews of the IRB and IMM approaches	**9**	14
	– Follow-up examinations of the IRB approach	**4**	10
	– Internal model recognition assessment and review of the IMM approach	**5**	1
	– IT aspects of the IRB approach	**–**	3
	Internal capital adequacy assessment process and economic capital	**8**	–
	Credit risk management and asset quality	**40**	49
	Market risk and treasury activities	**7**	15
	Firm-wide stress testing and liquidity risk management	**6**	–
	Securities, investment and insurance products-related conduct examinations	**30**	11
	Compliance with the Deposit Protection Scheme Representation Rules and Guideline on Representation on Full Deposit Guarantee#	**7**	19
	Consumer protection	**1**	–
	AML/CFT controls	**11**	14
	IT, Internet banking and operational risk	**18**	19
	Remuneration system	**10**	–
	Mainland-related business	**9**	–
	Renminbi payment system	**1**	–
	Renminbi business	**2**	6
2	Off-site reviews and prudential interviews	**193**	190
3	Tripartite meetings	**1**	12
4	Meetings with board of directors or board-level committees of AIs	**8**	7
5	Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	**223**	241
6	Reports commissioned under section 59(2) of the Banking Ordinance	**4**	3
7	Cases considered by the Banking Supervision Review Committee	**10**	5
8	AIs that were subject to the exercise of powers under section 52 of the Banking Ordinance	**1**	1

Examinations conducted in 2011 covered the compliance with the Deposit Protection Scheme Representation Rules only as the Full Deposit Guarantee expired at the end of 2010.

Powers under section 52 of the Banking Ordinance

Melli Bank Plc continues to be subject to the exercise of powers under section 52 of the Banking Ordinance. The directions imposed by the Monetary Authority (MA) on 25 June 2008 under section 52(1)(A) of the Banking Ordinance on the affairs, business and property of the Hong Kong Branch of Melli Bank Plc remained in force during 2011. The HKMA will continue to communicate regularly with the relevant authorities to monitor developments related to the branch and its head office in the UK and will review the supervisory measures taken to protect the interests of the AI's depositors.

CAMEL rating review

The CAMEL Approval Committee reviewed and determined the composite CAMEL ratings[1] of 195 AIs. The AIs were notified of the ratings and were given the opportunity to request a review, although none did so.

The CAMEL ratings of licensed banks on 20 October 2011 were used as the supervisory ratings provided to the Hong Kong Deposit Protection Board for the purpose of determining the contributions to be paid by Scheme members in 2012 under the Deposit Protection Scheme.

Specialised supervisory work

Supervision of technology risk

The use of Internet banking services continued to grow: the number of personal Internet banking accounts increased to 7.7 million (from 7.0 million in 2010), and there were 658,000 corporate Internet banking accounts (up from 573,000 in 2010). Among the 67 AIs offering Internet banking services, 59 AIs, including all of the 42 that offer high-risk transactions (such as fund transfers to unregistered third-party accounts) through Internet banking, have implemented two-factor authentication and some 4.1 million customers have registered for this service.

[1] Comprising the **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity components.

The HKMA issued a circular on 1 June 2011 requiring AIs to implement chip-based technology on all Automatic Teller Machine (ATM) services in Hong Kong as part of an on-going effort to enhance the security for ATM services. AIs are expected to upgrade their ATM terminals by the end of February 2013. Card replacement should be completed by March 2014 for debit cards and credit cards linked to cardholders' bank accounts, and by the end of 2015 for remaining credit cards.

To address the potential risk to Internet banking security arising from the introduction of SMS forwarding services by the telecommunications industry, the HKMA and the banking industry worked with the mobile telephone operators to implement additional controls to prevent fraudsters from using such services to forward one-time SMS passwords from a customer's registered mobile phone to the fraudster's mobile phone. The measure was implemented on 30 October.

The HKMA conducted regular on-site examinations and off-site surveillance of AIs' controls over Internet banking, technology risk management and business continuity planning. Separately, the HKMA extended the coverage of the supervisory control self-assessment process for Internet banking, technology risk management and business continuity planning to 78 AIs (from 73 in 2010).

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

Supervision of operational risk

In 2011 the HKMA enhanced its existing operational risk profiling system for analysing information gathered from the annual self-assessment on operational risk management. The self-assessment covered 77 AIs (compared with 76 in 2010). This exercise revealed that the selected AIs had in general established an operational risk management framework in line with the supervisory requirements. In addition, the operational risk management specialist team conducted on-site examinations on three AIs to review their policies and controls for operational risk.

Benchmarking stress-testing practices of AIs

The HKMA conducted a benchmarking exercise to assess and compare the effectiveness of selected AIs' firm-wide stress-testing practices, focusing on practical aspects of the effective implementation of risk management techniques and control procedures. The exercise found that the majority of the selected AIs had adopted reasonable policies and procedures to guide their stress-testing exercises. Some deficiencies were noted in a few areas where stronger governance, stricter control processes, more prudent business assumptions and greater discipline in taking risk-mitigating actions would ensure more effective implementation of the policies and procedures. The HKMA issued a circular on 4 August 2011 to share the observed sound practices with the industry.

Supervision of securities, investment products, insurance and Mandatory Provident Fund-related businesses

The HKMA co-operated closely with the Securities and Futures Commission (SFC), the Office of the Commissioner of Insurance (OCI) and the Mandatory Provident Fund Schemes Authority (MPFA) on the supervision of AIs' securities, insurance and Mandatory Provident Fund (MPF)-related businesses. Regular contact was maintained through bilateral and multilateral meetings, and under the auspices of the Council of Financial Regulators.

The HKMA engaged, jointly with the SFC, a service provider to undertake a mystery shopping programme to assess retail banks' compliance with regulatory requirements covering sales of unlisted securities and structured deposits in 2010. The HKMA published the findings of the exercise in May 2011. AIs were required to give due regard to the issues identified and were encouraged to adopt the good practices set out in the report.

The HKMA worked closely with the SFC and the Stock Exchange of Hong Kong Limited to help the industry ensure its operational readiness for the listing of products denominated in renminbi. In this connection, the HKMA issued three circulars to AIs in February and March.

In view of the popularity of investment-linked assurance scheme (ILAS) products and their salient features and risks, the HKMA issued guidance to the industry on 14 March to strengthen the regulation of AIs' sales of such products.

Following the introduction of the pilot scheme for streamlining the sales of renminbi retail bonds and the implementation of new investor protection measures for less experienced investors, including a pre-investment cooling-off period, the HKMA issued guidance in April to streamline AIs' sales processes for plain vanilla investment products and to allow vulnerable investors to choose whether to have a companion as witness and/or to have a second front-line staff member to handle the sales process.

In view of the popularity of currency-linked instruments and interest-rate linked instruments issued by AIs and the exemption of such instruments from the authorization requirements under the Securities and Futures Ordinance, the HKMA developed templates for Important Facts Statement to enhance the disclosure of key features and risks of such products for distribution to retail customers. Guidance was issued to AIs in April to implement this requirement.

The HKMA issued guidance in October to further elaborate the standards of conduct expected of AIs selling accumulators. In particular, the selling of accumulators should be justified with specific grounds acknowledged by the customer.

The HKMA also stepped up its efforts in investor education, issuing *inSight* articles to highlight key features and risks of exchange-traded funds and accumulators in August and September respectively.

The HKMA allocated additional resources to on-site examinations related to securities, investment and insurance products. The specialist teams conducted 30 on-site examinations, up from 11 in 2010, covering the distribution of accumulators and decumulators as well as investment products not regulated under the Securities and Futures Ordinance, sponsorship activities for initial public offerings (IPOs), private placements, compliance with the enhanced regulatory requirements for selling of investment products, ILAS and non-linked long-term insurance products. The HKMA published a report in November on common deficiencies and key areas of concern identified in the thematic on-site examinations of IPO sponsorship activities. In addition, the HKMA issued a circular drawing the report to the attention of all bank IPO sponsors and reminding them of the regulatory standards required of them in performing these activities.

The HKMA processed three applications to become registered institutions (RIs) and five applications from RIs to engage in additional regulated activities. It also granted consent to 261 Executive Officers, who are responsible for supervising the securities activities of RIs, and conducted background checks on 9,578 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

During the year the HKMA continued to work with the Financial Services and the Treasury Bureau (FSTB) and the OCI to engage the banking industry and other stakeholders in formulating the future regulatory framework governing the distribution of insurance products after the proposed independent Insurance Authority is established. The HKMA also continued to co-operate with the FSTB and the MPFA to formulate the statutory regime to regulate MPF intermediaries, in preparation for the implementation of the Employee Choice Arrangement.

Supervision of treasury activities

Of the 13 treasury examinations conducted on selected AIs during 2011, seven mainly covered AIs' control framework for managing market risk and counterparty credit risk arising from their treasury and derivatives activities. The remaining six focused on firm-wide stress testing, liquidity risk management and interest rate risk management.

In addition to the on-site examinations and the benchmarking exercise on stress-testing practices, the HKMA continued to devote considerable resources to monitoring emerging financial market and treasury product trends with potential material market risk or systemic implications, and providing specialist opinion on material or emerging risks in relation to AIs' treasury and derivatives operations.

Credit risk management and asset quality

Credit growth

The banking sector's total lending increased by 20.2% in 2011, although the pace of growth moderated in the second half. Overall, the growth in bank lending for use in and outside Hong Kong, and for trade finance was slower than in 2010 (Table 2).

Table 2 Growth in loans and advances

% change	**2011**	2010
Total loans and advances	**20.2**	28.6
of which		
– for use in Hong Kong	**12.8**	20.9
– trade finance	**26.9**	56.7
– for use outside Hong Kong	**41.2**	50.3

The HKMA has been closely monitoring the credit growth of AIs because of the potential stress on credit quality and liquidity risk management. Early in the year, AIs were required to submit their business plans and funding strategies to the HKMA for review. Where considered appropriate, the HKMA requested AIs to revise their business plans having regard to the sustainability of stable funding to support their lending activities. More frequent on-site examinations were conducted to review the loan portfolios of AIs whose credit growth, including Mainland-related businesses, had grown significantly. Overall, the results showed no apparent deterioration in the credit underwriting standards and credit risk management of AIs. To build a stronger buffer against possible deterioration in asset quality, the HKMA also discussed with the retail banks the need to increase the level of their regulatory reserves by the end of 2011. As a result, the relevant retail banks' regulatory reserves (including their collective impairment allowances) are expected to reach 1.4% of their total lending once the agreed levels are attained, compared with 0.85% at the end of 2010.

Prudential supervision of mortgage loans

The HKMA remained vigilant towards AIs' property mortgage business, which constitutes a significant portion of their lending portfolios. As property prices continued to rise in the first half of 2011, the risk of a property bubble, which might potentially undermine the stability of the banking system, persisted. Against this background, the HKMA introduced on 10 June the fourth round of countercyclical macro-prudential measures. The measures were:

(1) Lowering the maximum loan-to-value (LTV) ratios to:

- 50% for residential properties valued at $10 million or more
- 60% for residential properties valued at $7 million or more but below $10 million, subject to a loan cap of $5 million
- 70% for residential properties valued at less than $7 million, subject to a loan cap of $4.2 million.

(2) Lowering the maximum LTV ratio for properties under net worth-based mortgage lending from 50% to 40%.

(3) Lowering the applicable maximum LTV ratio by at least 10 percentage points for mortgage loans from applicants whose principal income is derived from outside Hong Kong.

(4) Requiring AIs to consider the need to apply more stringent credit underwriting standards when lending to borrowers with multiple outstanding mortgages.

These macro-prudential measures have strengthened the risk management standards and practices of AIs in their mortgage lending business. This also enables AIs to build up a larger safety cushion to absorb potential losses arising from a property market downturn. The LTV ratio for new residential mortgage loans reduced to around 53% in December 2011 from 64% in September 2009 before the first round of measures was introduced.

To monitor AIs' compliance with the prudential requirements on property mortgage lending, the HKMA undertook a round of thematic on-site examinations in 2011. The results indicated that AIs generally complied with the requirements.

The HKMA will continue to monitor the property and mortgage markets closely and introduce appropriate measures to safeguard banking stability as and when necessary.

European sovereign debt crisis

Although AIs do not have significant exposures to the European countries facing sovereign debt problems, the banking sector may suffer from spill-over if the fiscal problems of some European countries lead to heightened risk aversion and trigger capital outflows from emerging markets or a liquidity squeeze in the interbank market. In the light of the volatile market conditions in the second half of 2011 and as part of our on-going supervisory process, the HKMA has been closely monitoring the funding and liquidity positions of foreign AIs, particularly those from Europe, including their access to the interbank market and deposit movements. These AIs have also been asked to step up their contingent funding plans and to maintain sufficient high-quality liquefiable assets to meet any unexpected developments. In addition, the HKMA has stepped up its communication with the home supervisors of some European AIs on matters concerning the latest financial conditions of their head offices and market developments.

Mainland-related business

Renminbi banking business

Since April, AIs participating in renminbi business have been able to place renminbi funds in excess of their day-to-day business and settlement needs in a segregated Fiduciary Account with the People's Bank of China through the Renminbi Clearing Bank. With the introduction of the Fiduciary Account, the HKMA allows the outstanding balance maintained in it to be included when calculating the renminbi risk management limit, which requires a participating AI to maintain the sum of its renminbi cash, its settlement account balance with the Renminbi Clearing Bank and the balance maintained in the Fiduciary Account at not less than 25% of its renminbi customer deposits. The HKMA also allows the exposure under the Fiduciary Account to be exempt from the large exposure framework prescribed by the HKMA.

Having considered the need for orderly development of renminbi business and industry comments, the HKMA issued a circular on 28 July introducing some refinements to the management of AIs' renminbi net open positions. This allows a de minimis exemption of RMB50 million to the principal requirement that an AI's renminbi net open position should not be larger than 10% of its renminbi balance sheet. The HKMA also allows AIs to exclude their actual amount of investments under the Qualified Foreign Institutional Investors (QFII) regime on the Mainland and positions arising from renminbi bond market-making activities if their net open positions exceed the 10% limit. The excess can also be offset against net renminbi deliverable forward positions in the opposite direction. Notwithstanding these refinements, the HKMA has requested AIs not to leverage on the refinements in ways that might undermine the orderly development of renminbi business in Hong Kong and proper risk management by AIs regarding their renminbi positions.

Under the same circular, participating AIs handling cross-border trade settlement business in renminbi are allowed to consolidate the renminbi trade positions of banks outside Hong Kong that are part of the same bank group as the AI concerned with its own renminbi trade position for the purpose of position squaring with the Renminbi Clearing Bank on a net basis.

To ensure the proper use of the supplementary renminbi conversion channel for position squaring, the HKMA issued a circular on 8 November to clarify the requirements on position squaring in respect of renminbi trade settlement transactions with the Renminbi Clearing Bank and to elaborate on the HKMA's supervisory expectations in that regard. The circular gave additional guidance on how to determine which cross-border trade transactions are eligible for position squaring with the Renminbi Clearing Bank. Participating AIs were requested to be vigilant to cross-border merchandise trade transactions that are artificially structured to "round-trip" through Hong Kong or other locations into the Mainland. The HKMA also reiterated its requirements for adequate know-your-customer and due diligence procedures and the need to request third-party supporting documents from customers where necessary to substantiate the flow and genuineness of trade transactions. To ensure adequate monitoring of compliance with the requirements, participating AIs are required to conduct reviews of their top 10 renminbi cross-border merchandise trade transactions or renminbi remittances to verify compliance with the relevant requirements if a net total of RMB200 million or above is squared with the Renminbi Clearing Bank within a month.

The HKMA continued to conduct on-site examinations of AIs' renminbi banking business during the year and the results were generally satisfactory.

Tapping the Mainland market

There were 13 locally incorporated banks with business operations on the Mainland during the year, of which eight were operating through subsidiary banks incorporated on the Mainland. They continued to expand their branch network, maintaining over 330 Mainland branches or sub-branches, either directly or through subsidiary banks.

The industry's aggregate on-balance-sheet non-bank exposures to the Mainland amounted to the equivalent of HK$2,021.0 billion at the end of 2011, or 13.0% of total assets. These included exposures of HK$546.6 billion booked at the Mainland subsidiaries of Hong Kong banks. Compared with 2010, the aggregate exposures grew by 44.8%.

In view of the increasing Mainland-related business conducted by AIs, in September the HKMA clarified its supervisory expectations in relation to these activities. The HKMA requested AIs to ensure compliance with Mainland legal and supervisory requirements when conducting Mainland-related activities. Thematic examinations on AIs active in these areas of business were conducted.

With the increasing importance of the Mainland market to AIs, the HKMA has enhanced communication with the China Banking Regulatory Commission to ensure effective cross-border supervisory co-operation and co-ordination.

Prevention of money laundering and terrorist financing

The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance was gazetted on 8 July 2011 and came into operation on 1 April 2012. The Ordinance codifies customer due diligence and record-keeping requirements, and provides for supervisory and criminal sanctions when breaches occur. Following consultation with the banking industry, a guideline on the new legislative and regulatory requirements had been issued and became effective on 1 April 2012.

The AML/CFT specialist teams continue to monitor AIs' compliance with the HKMA's regulatory requirements. The teams completed 11 on-site examinations during the year, including 10 Tier-2 examinations and one thematic examination.

Co-operation with supervisors outside Hong Kong

During the year the HKMA participated in college-of-supervisors meetings organised by the home supervisors of 14 banking groups with significant operations in Hong Kong. Issues of common interest were discussed, including market trends, key areas of supervisory attention, stress testing, credit, liquidity, market and other types of risk management and Basel II implementation.

Bilateral meetings were held within and outside Hong Kong with banking supervisory authorities from Australia, France, Indonesia, Japan, Liechtenstein, Macau, the Mainland, the Netherlands, the Philippines, Singapore, South Africa, South Korea, Sweden, Switzerland, Taiwan, Thailand, the UK and the US. There were also regular exchanges with overseas banking supervisory authorities on institution-specific issues and developments in financial markets.

The HKMA is a member of the crisis management groups of three major banking groups organised by the relevant home authorities to discuss and oversee the production of a Recovery and Resolution Plan for each banking group in accordance with the relevant principles established by the Financial Stability Board (FSB). Through its membership, the HKMA also contributed its views on the cross-border resolution framework in the FSB Cross-Border Crisis Management Working Group.

Remuneration practices

A round of thematic examinations on the remuneration systems and practices of 10 selected AIs was conducted in the first quarter of 2011 to assess their compliance with the HKMA's "Guideline on a Sound Remuneration System" issued in March 2010. In general, the results indicated that the AIs' progress in implementing the HKMA's Guideline was satisfactory and their remuneration policies and practices broadly complied with the established principles and standards.

Enhancement to management information system

A project to revamp the HKMA's management information system of statistical data collected from AIs was initiated in 2011 to better assist the supervisory teams in performing their duties.

Basel II

Enhancements to Basel II

The HKMA, in collaboration with the FSTB and the Department of Justice, amended the Banking (Capital) Rules (BCR) and the Banking (Disclosure) Rules to implement the enhancements to the Basel II regulatory capital framework issued by the Basel Committee in July 2009.[2] The package of measures involves the following enhancements:

- raise capital requirements substantially for securitisation transactions (particularly for complex securitisation transactions) held in the banking book, and extend the enhanced securitisation framework to securitisation exposures held in the trading book

- introduce additional market risk capital charges to better capture price changes due to issuer default and changes in the credit ratings of credit-sensitive products, as well as incorporating stress elements into market risk calculations based on historical experience

- strengthen valuation requirements to ensure prudent and reliable valuation of fair-valued exposures held in both the trading and banking books, taking into account the liquidity of the exposures

- enhance disclosure requirements with respect to securitisation and market risk activities.

In amending the Rules, the HKMA took the opportunity to introduce some refinements to address practical issues and ambiguities identified in the course of implementing the Rules since their introduction in 2007; and to include additional credit rating agencies as external credit assessment institutions for the purpose of calculating regulatory capital.

The amended Rules were the subject of several rounds of industry consultation during the year, prior to submission to the Legislative Council in October 2011 for negative vetting. The negative vetting process was completed in November 2011 and the amended Rules came into effect on 1 January 2012.

The regulatory return relating to AIs' capital adequacy ratio (CAR) and the accompanying completion instructions were revised to reflect the amendments made to the BCR. Other relevant supplementary guidance was also updated to assist AIs incorporated in Hong Kong in complying with the amended Rules.

[2] The enhancements to Basel II are set out in the Basel Committee papers, *Revisions to the Basel II Market Risk Framework*, *Guidelines for Computing Capital for Incremental Risk in the Trading Book*, and *Enhancements to the Basel II Framework*, originally released in July 2009 and, in the case of the first paper, updated in February 2011.

Implementation of advanced approaches

During the year the HKMA granted approval to another AI to adopt the IMM approach under the market risk capital framework of the BCR, after assessing the AI's internal models and market risk management systems against the minimum requirements set out in the BCR.

Those AIs that had already obtained the MA's approval to use the IMM approach prior to 1 January 2012, when the amended BCR took effect, were required to obtain additional approvals from the MA to continue using this approach on and after that date. The HKMA conducted reviews to assess the compliance of these AIs with the revised minimum requirements for adopting the IMM approach (including the calculation of the newly introduced additional market risk capital charges). The results of these reviews were generally satisfactory, and form the basis for granting approval for the AIs to continue using the IMM approach.

Several AIs previously approved by the MA to use the IRB approach for the calculation of regulatory capital for credit risk changed their internal rating systems during the year to reflect the availability of more comprehensive data and refinements to the existing methodology. The HKMA reviewed the changes to ascertain the AIs' continued compliance with the requirements for the use of the IRB approach, taking into account both the extent of the changes made and their materiality in terms of impact on the AIs' regulatory capital.

Supervisory review process

The supervisory review process (SRP) which forms Pillar 2 to the Basel II capital framework (Pillar 1 being the calculation of capital requirements for credit, market and operational risks and Pillar 3 being disclosure) provides the HKMA with a comprehensive framework for assessing the capital levels and risk profiles of AIs incorporated in Hong Kong, including in respect of non-credit-related risks such as interest rate risk in the banking book as well as liquidity, reputation and strategic risks.

In 2011 the HKMA completed a round of SRP assessments on Hong Kong-incorporated AIs, which included a review of their progress in establishing or enhancing their CAAPs. The SRP Approval Committee within the HKMA reviewed the assessment results for the purpose of considering both the appropriate minimum CARs to be required of the AIs and whether there were other supervisory issues warranting attention. The AIs were notified of the results, and were given the opportunity to request a review of their minimum CAR, although none did so.

Under CAAP, AIs assess internally whether their overall capital adequacy is commensurate with the risk profile of their operations and formulate a strategy for maintaining adequate capital levels. Since the implementation of Basel II, a number of AIs have substantially established their CAAPs and have been submitting the results to the HKMA for review. Notable progress has also been observed among some other AIs in that the policies and procedures for their CAAPs are now largely in place. In addition to its regular SRP reviews, the HKMA has started a round of more focused thematic reviews of selected AIs to identify sound practices for conducting CAAP, having regard to their risk profiles and the sophistication of their operations. These reviews will continue in 2012.

Basel III

Implementation of Basel III in Hong Kong

Following the issue of the Basel III reform package by the Basel Committee on Banking Supervision in December 2010[3], the HKMA issued a circular in January 2011 informing AIs of its intention to implement Basel III in Hong Kong in accordance with the Basel Committee's timetable (i.e. between 1 January 2013 and 1 January 2019) and of the need to introduce legislative amendments to give effect to the new capital, liquidity and disclosure requirements.

In essence, Basel III strengthens the global capital framework by improving the quality of the regulatory capital base; raising the minimum regulatory capital requirements (with greater emphasis on common equity); introducing two capital buffers (a "Capital Conservation Buffer" and "Countercyclical Capital Buffer") to reinforce the resilience of banks and reduce the impact of economic downturns on their credit intermediation activities; introducing a supplementary leverage ratio as a backstop to risk-weighted capital measures; and enhancing the transparency of the capital base.

Basel III also introduces two global liquidity standards to achieve two separate but complementary objectives to make the banking sector more resilient to liquidity stress:

- *Liquidity coverage ratio (LCR)*: to promote short-term liquidity resilience by ensuring that banks have sufficient high-quality liquid assets to survive for at least 30 days under an acute stress scenario

- *Net stable funding ratio (NSFR)*: to promote longer-term resilience by requiring banks to hold minimum amounts of funding expected to be "stable" over a one-year time horizon under an extended stress scenario.

In addition, a set of liquidity monitoring tools is proposed for supervisors' on-going monitoring of banks' liquidity risk exposures in order to further strengthen and promote global consistency in liquidity risk supervision.

Banking (Amendment) Bill 2011

For the purpose of implementing Basel III in Hong Kong, a Banking (Amendment) Bill was introduced into the Legislative Council in December. The Bill builds upon the existing rule-making powers in the Banking Ordinance and provides for the capital, liquidity and disclosure requirements applicable to AIs to be set out in rules to be made by the MA. This legislative approach balances the need for clear binding requirements with the need to be able to amend regulatory standards swiftly and proactively to address changing business practices and environments. The rules will be subsidiary legislation subject to statutory consultation under the Banking Ordinance and negative vetting by the Legislative Council. To provide further guidance in respect of the rules, the MA will be able to issue, or approve, codes of practice. The Bill also broadens the remit of the Capital Adequacy Review Tribunal to cover specified decisions under the future liquidity rules, as well as appeals against decisions by the HKMA to issue remedial action notices in respect of, or to vary, individual AIs' capital and liquidity requirements, and renames it the Banking Review Tribunal.

The Bill was passed by the Legislative Council on 29 February 2012 and became the Banking (Amendment) Ordinance 2012. This should allow

[3] The Basel III reform package comprises two Basel Committee papers, *Basel III: A Global Framework for More Resilient Banks and Banking Systems,* and *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring,* setting out the details of the new global regulatory standards on bank capital adequacy and liquidity designed to strengthen the resilience of the global banking system and reduce the probability and severity of future banking crises.

Basel III (continued)

sufficient time for the development of the rules, and for AIs to introduce the necessary system changes in advance of the deadlines in the Basel Committee's timetable.

The HKMA will issue detailed policy proposals for the contents of the rules during 2012.

The HKMA will also monitor the approaches of other jurisdictions to the implementation of Basel III including, particularly, the adoption of more stringent standards (both in terms of minimum requirements and/or implementation timelines), and will assess any potential impact on Hong Kong, having regard to factors such as competitive issues, local circumstances and overall global economic conditions.

Capitalisation of exposures to central counterparties

The Basel Committee followed the release of its first consultative paper *Capitalisation of Bank Exposures to Central Counterparties* in December 2010 with a second consultative paper in November 2011 setting out revised proposals for the capital treatment of banks' counterparty credit risk exposures to central counterparties (CCPs). Most of the revisions related to the methodology for calculating the capital requirement for default fund exposures (generally speaking, this capital requirement addresses the risk of a clearing member of a CCP losing its contribution to the CCP's loss sharing arrangements if another clearing member of the CCP defaults). Given the potential implications for the banking sector, the HKMA encouraged the two industry associations to consult their members on the revised proposals and to send a co-ordinated response to the Basel Committee. The Basel Committee is finalising the proposals. The HKMA will work with the industry to adopt the new standards in Hong Kong in accordance with the Basel Committee's timetable once the finalised proposals are released.

Global systemically important banks and capital buffers

During the year the Basel Committee and the Financial Stability Board (FSB) made significant progress in their work related to the risks posed by global systemically important banks (G-SIBs) and in particular the means by which both the likelihood and the impact of the failure of such an institution may be reduced. The text of the rules on *Global systemically important banks: assessment methodology and the additional loss absorbency requirement* was published by the Basel Committee in November 2011, setting out the framework and methodology for assessing the systemic importance of G-SIBs and the additional loss absorbency to be required of G-SIBs. The FSB concurrently announced an initial group of 29 G-SIBs (none of which is incorporated in Hong Kong), identified on the basis of the Basel Committee's assessment methodology.

Requirements for G-SIBs' additional loss absorption capacity, to be met by common equity, have been set within a range of 1% to 2.5% of their risk-weighted assets (although the upper limit can extend to 3.5% to discourage banks from becoming even more systemically important). Attributes for national resolution regimes and standards for more intensive supervision of G-SIBs have been agreed. As the higher loss absorbency requirements for G-SIBs will form part of their capital conservation buffers under Basel III, the requirements will be introduced in parallel with the relevant Basel III timeline (i.e. between 1 January 2016 and the end of 2018, to become fully effective on 1 January 2019).

Basel III (continued)

The Basel Committee issued guidance on the operation of the countercyclical capital buffer in December 2010. The HKMA is currently analysing the technical aspects of, and the options for the institutional arrangements underlying, the operation of the countercyclical capital buffer in Hong Kong.

Application of Pillar 2 under Basel III

Basel III focuses primarily on Pillar 1 requirements and does not provide specific guidance on how the Pillar 2 SRP process should be integrated into the new capital framework. The HKMA is currently considering the appropriate integration approach for Hong Kong, taking into account local circumstances and the approaches adopted in some major jurisdictions. The overarching principles guiding the HKMA's current thinking are that (i) amid international efforts to strengthen banking resilience through higher capital standards, the fundamental concept of Pillar 2 should remain as important under Basel III as it is under Basel II; and (ii) any approach to integration should not result in a disproportionate capital impact on AIs. The work in this area will continue into 2012.

Liquidity standards and monitoring tools

As noted above, the HKMA intends to follow the Basel Committee's timetable to implement the LCR on 1 January 2015 and the NSFR on 1 January 2018. Some banks will be required to report, in a fashion similar to that adopted by the previous quantitative impact studies (QIS) conducted by the Basel Committee on implementing enhancements to the Basel II framework, on their position vis-à-vis the two standards from 2012 to facilitate the HKMA's monitoring of behavioural changes and other consequences of the standards during the observation period set by the Basel Committee. The HKMA also intends to adopt the Basel Committee's proposed liquidity monitoring tools in its on-going liquidity risk supervision by 2015. The new liquidity standards will be set out in rules to be made by the MA under the Banking (Amendment) Ordinance 2012, supplemented where necessary by codes of practice and guidelines.

In developing its implementation proposals, the HKMA has taken into account the results of a series of liquidity QIS and other surveys conducted in 2010 and 2011, as well as issues raised during bilateral discussions with selected AIs. The information collected has better enabled the HKMA to assess the impact of the liquidity standards on different types of AI and obtain insight into the likely behavioural changes of AIs in response to the standards.

Major policy issues under consideration

The HKMA started consulting the industry on its initial policy proposals in early 2012 including issues such as:

- *25% minimum liquidity ratio*: Whether the existing statutory ratio under the Banking Ordinance should be retained and, if so, whether it needs to be modified. The extent to which the existing ratio differs from, or interacts with, the LCR (e.g. in terms of policy objective and impact) is relevant here

- *Scope of application*: Whether the LCR and NSFR should apply uniformly to all AIs; or whether they should only apply to a class (or classes) of AIs. A particular issue is whether the standards should apply to branches of foreign banks, which may be subject to comparable standards in their home jurisdiction on a consolidated basis

- *Discretionary items within the liquidity standards*: These include items specifically subject to national discretion under Basel III and a range of definitional issues.

Basel III (continued)

HKMA's participation in Basel III working groups

As a member of the Basel Committee and its governing body, the Group of Governors and Heads of Supervision, the HKMA has continued to participate in the Committee's work on the development of the Basel III framework, including through its membership of the Committee's working groups, including the Working Group on Liquidity, the Definition of Capital Subgroup, and the Quantitative Impact Study Working Group (QIS Working Group). These working groups have been tasked with addressing important outstanding issues relevant to the application of the Basel III standards. Some of these are of particular relevance to Hong Kong, such as the development of a framework to allow jurisdictions with an insufficient supply of high-quality liquid assets denominated in their local currency to adopt an alternative treatment under the LCR to cover their banks' potential liquidity needs. The HKMA has contributed actively to the discussions in these areas.

Basel III implementation monitoring process

In 2011 the HKMA continued to contribute data from selected Hong Kong-incorporated AIs to the Basel Committee's QIS Working Group to facilitate both the assessment of the impact of the Basel III requirements and the monitoring of banks' implementation progress in member jurisdictions. This implementation monitoring is expected to be repeated semi-annually during the transitional period before full implementation of the Basel III framework.

The HKMA has also carried out a similar implementation monitoring exercise locally on a broader sample of AIs. Based on the results to date, AIs in Hong Kong appear generally well placed to meet the new capital standards, given that they tend to be well capitalised and rely mainly on common equity to meet their regulatory capital requirements. AIs are also not expected to encounter major difficulties in complying with the new liquidity standards over the transition period. Nevertheless, some AIs may need to adjust their liquidity profiles or liquid asset composition to satisfy the relevant requirements.

Improving the supervisory policy framework

Revision of liquidity regime

In April the HKMA issued a supervisory guideline "Sound Systems and Controls for Liquidity Risk Management" to provide detailed guidance on how AIs are expected to comply with the enhanced risk management standards set out in the *Principles for Sound Liquidity Risk Management and Supervision* published by the Basel Committee in September 2008 (Liquidity Sound Principles). AIs are required to agree an implementation plan with the HKMA, which will monitor implementation progress. Internally, the HKMA has also enhanced aspects of its supervisory process with regard to those of the Liquidity Sound Principles specifically applicable to supervisors. Among other things, significant progress was made in developing intraday liquidity monitoring indicators for supervisory purposes.

Competence and ethical behaviour

In July the HKMA issued a new supervisory guideline "Competence and Ethical Behaviour", taking into account comments received from the industry in an earlier consultation. The guideline sets out supervisory expectations regarding measures to be adopted by AIs to monitor and maintain the competence and ethical behaviour of their staff. AIs have been requested to review their existing arrangements against the new guideline and take steps to address any deficiencies as soon as practicable.

Stress testing

The HKMA consulted the industry on the revision of the supervisory guideline "Stress-testing", incorporating the *Principles for Sound Stress Testing Practices and Supervision* issued by the Basel Committee in May 2009 together with recommendations from other international organisations to address deficiencies in stress-testing practices revealed by the global financial crisis.

Corporate governance

To strengthen its supervisory guidance on corporate governance, the HKMA released for industry consultation in October a revision of its existing guideline "Corporate Governance of Locally Incorporated Authorized Institutions" to bring it into line with international standards and best practices set out in the *Principles for Enhancing Corporate Governance* issued by the Basel Committee in October 2010. The draft revision focuses, among other things, on board and senior management oversight (including their understanding of the group structure and business), the functioning, organisation and evaluation of the board, and the disclosure of key corporate governance and risk management information. The HKMA will take into account comments received from the industry in finalising the revised guideline.

Improving the supervisory policy framework (continued)

Remuneration practices

The HKMA issued a circular letter in November encouraging AIs to make disclosure in line with the paper *Pillar 3 Disclosure Requirements for Remuneration* issued by the Basel Committee in July 2011, in addition to the disclosures set out in the HKMA's existing "Guideline on a Sound Remuneration System". The Basel Committee paper contains more specific requirements for the disclosure of qualitative and quantitative information, further to the requirements in its supplemental Pillar 2 guidance issued in July 2009. AIs are encouraged to make disclosures at least annually with effect from the financial year 2011, and on a proportionate basis, having regard to the extent to which they use incentive-based compensation and the size, scope, nature and complexity of their business.

Prudent valuation

Following industry consultation, the HKMA issued the guideline "Financial Instrument Fair Value Practices" in December superseding its previous guideline "Use of the Fair Value Option for Financial Instruments". The new guideline incorporates the Basel Committee's *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices*, issued in April 2009 (and reflected in the Basel Committee's July 2009 enhancements to Basel II) designed to strengthen and promote transparency of banks' prudent valuation of exposures that are measured at fair value. The scope of the guidance has been extended to cover all positions that are accounted for at fair value, whether in banking book or trading book. The guidance also clarifies that regulators should retain the ability to require adjustments to the current value of relevant exposures beyond those required by financial reporting standards, in particular, where there is uncertainty about the current value. In developing its guideline, the HKMA closely followed the Basel Committee's guidance, taking into account comments from the banking industry and the Hong Kong Institute of Certified Public Accountants.

Other policy development work

A new Research and Development Unit was created within the HKMA's Banking Policy Department. This unit includes a number of policy experts with experience from overseas regulatory organisations. The Unit will analyse international policy developments and support the HKMA's contribution to policy formation at the international level.

A working group was established by the Basel Committee during the year to develop global standards for the regulation of banks' large exposures. While many jurisdictions, including Hong Kong, impose restrictions on large exposures, typically in the form of percentage limits measured against capital base, there is a lack of international harmonisation in this area. The working group is considering a range of microeconomic and systemic issues and analysing calibration and data needs. It will also focus on intra-group as well as shadow banking exposures. The working group is expected to issue a consultative document in 2012.

Accounting and disclosure

Accounting standards

In 2011, the International Accounting Standards Board (IASB) issued a number of new and revised International Financial Reporting Standards as part of its programme to enhance global accounting standards following the global financial crisis. Many of these will have implications for banks in Hong Kong. These include enhancements to fair-value measurement standards addressing valuation uncertainty when markets become less active and accounting requirements for consolidation and joint arrangements, and disclosure standards for off-balance sheet vehicles. The Hong Kong Institute of Certified Public Accountants (HKICPA), in turn, issued updated Hong Kong Financial Reporting Standards in line with the IASB's new requirements.

In addition, to enhance current accounting standards for impairment, the IASB has been working closely with the US Financial Accounting Standards Board to finalise a joint expected loss provisioning approach, with a re-exposure draft expected in 2012. The approach incorporates more forward-looking information about credit losses into impairment measurements and provides for earlier recognition of expected losses.

During the year the HKMA maintained a regular dialogue with the HKICPA's Banking and Regulatory Liaison Group on developments in global accounting standards, including their implications for AIs' financial reporting and the HKMA's supervisory framework, as well as on key supervisory policy developments.

Thematic review on risk disclosures

The FSB launched a thematic peer review in June 2010 on the implementation of the recommendations concerning risk disclosures by market participants set out in its April 2008 report "Enhancing Market and Institutional Resilience". The HKMA participated as a member of the review team. The review was completed in early 2011 and the final review report published on 18 March, setting out recommendations on the areas of risk disclosure mainly related to Special Purpose Entities and off-balance sheet exposures where further improvement is needed.

As far as Hong Kong is concerned, locally incorporated AIs' disclosures in these respects were generally in compliance with the recommendations of the Senior Supervisors Group Report, where applicable.

As a first step towards taking forward the recommendations, the FSB organised a Roundtable on Risk Disclosure on 9 December, in which the HKMA participated, alongside other regulators, standard setters, audit firms and market practitioners. The objective was to foster a constructive dialogue among key parties (including those from the private sector) for the purpose of enhancing the transparency and relevance of risk disclosures, having regard to prevailing market conditions.

Consumer protection

Code of Banking Practice

As part of its continuing efforts to strengthen consumer protection in the banking industry, the HKMA commenced on-site examinations to review AIs' compliance with the Code of Banking Practice, supplementing the regular self-assessments conducted by AIs. In the industry's self-assessment covering the period from 1 January to 31 December 2010, all AIs reported full, or almost full, compliance[4], with the Code. At the HKMA's request, the Code of Banking Practice Committee started a review of the Code to further enhance the standard of banking practices. The review will continue in 2012 with the HKMA participating as a member of the Committee.

Enhanced credit card practices

The HKMA has been working with the Hong Kong Association of Banks (HKAB) to introduce enhanced credit card practices, with reference to enhancements adopted recently in the UK and US, to promote fair and responsible business practices by credit card issuers. Some of the measures will reduce cost to customers, while increased disclosure will enable customers to compare products and services among AIs and make better-informed decisions. HKAB announced the first two batches of 22 practices in the first half of 2011. Most of them have already been implemented while some, which require significant systems enhancement, are scheduled to be implemented

[4] With five or fewer instances of non-compliance.

in 2012. The third (and last) batch of nine practices was announced in March 2012 for implementation in 2012 and 2013.

Proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre

The HKMA has been assisting the FSTB on the proposed establishment of an Investor Education Council and a Financial Dispute Resolution Centre (FDRC). The FDRC is expected to come into operation in mid-2012. During 2011 the HKMA continued to participate in the working group set up by the FSTB to provide advice on the operational details of the FDRC.

G20 High-level Principles on Financial Consumer Protection

The HKMA served as a member of the FSB Consultative Group and the Task Force on Financial Consumer Protection of the Organisation for Economic Co-operation and Development (OECD), which are tasked with developing High-level Principles on Financial Consumer Protection and preparing a report setting out additional international work that could help advance such protection and financial stability. The *G20 High-level Principles on Financial Consumer Protection* were published in October.

Credit data sharing

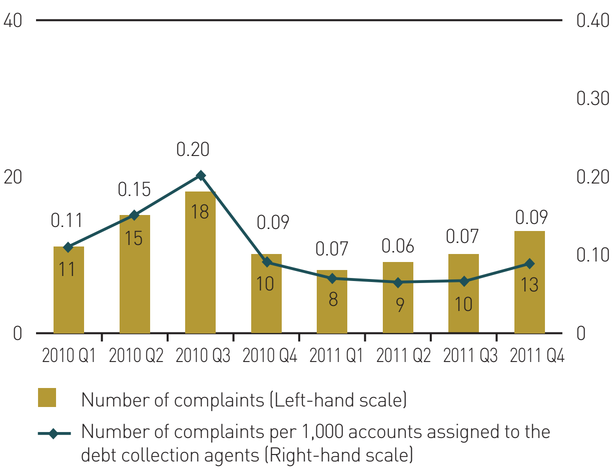
At the end of 2011, 118 AIs and AIs' subsidiaries were sharing commercial credit data through the Commercial Credit Reference Agency (CCRA). The scheme contained the credit data of more than 120,600 business enterprises, about 18% of which were sole proprietorships and partnerships. The continued development of the CCRA has helped to strengthen the credit risk management capacity of AIs and improve access to credit for small and medium-sized enterprises.

The HKMA continued to work with the industry and the Office of the Privacy Commissioner for Personal Data on the industry's proposal to expand consumer credit data sharing to include positive mortgage data. Following public consultation in January, the Privacy Commissioner for Personal Data amended the Code of Practice on Consumer Credit Data (the amended Code took effect on 1 April 2011), to allow the sharing of mortgage data among credit providers through the Credit Reference Agency to include positive mortgage data. This involves sharing of information on the number of mortgage loans held for residential and non-residential properties. The HKMA issued a circular to all AIs on 31 March setting out the steps they need to take to implement the scheme. The HKMA believes that the sharing of positive mortgage data will further strengthen credit risk management and is therefore conducive to the general stability of the banking system, which is crucial to the interests of depositors as well as the financial stability and economic development of Hong Kong.

Customer complaints relating to debt collection agents employed by AIs

The number of complaints received by AIs about their debt collection agents fell to 40 from 54 in 2010 (Chart 1). The HKMA will continue to ensure that AIs remained vigilant in monitoring the performance of their debt collection agents.

Chart 1 **Complaints received by AIs about their debt collection agents**



Enforcement

Re-engineering of the enforcement process

The complaint handling and enforcement process of the Enforcement Department on banking services and products was overhauled to make it more efficient and to improve communication with complainants. The processing cycle has been shortened and a single case team is made responsible for a complaint from inception to imposition of sanctions, if any. The Complaint Processing Centre has been established as the initial contact point for complainants. Where no further action is taken on a complaint, the reasons will be explained to the complainant to the extent allowed by applicable legislation.

In conjunction with these changes, the Banking Enforcement Management System was launched to enhance management information, facilitate record keeping and retrieval and guide users through the essential steps to ensure procedural compliance.

Several sound-proof interview rooms were installed with audio recording to make the interview process more efficient.

Investigation interview facilities.

Banking complaints

The HKMA received 2,326 complaints about banking services or products in 2011, compared with 1,675 in 2010 (Chart 2). The services or products concerned included credit cards, investment products, savings and deposits, and loans and credit facilities (Chart 3).

Chart 2 **Number of banking complaints received by the HKMA**

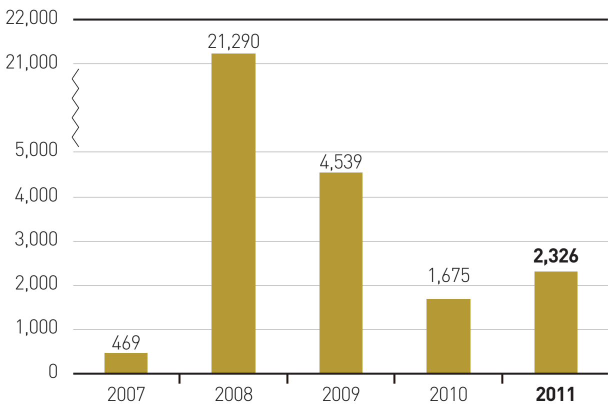
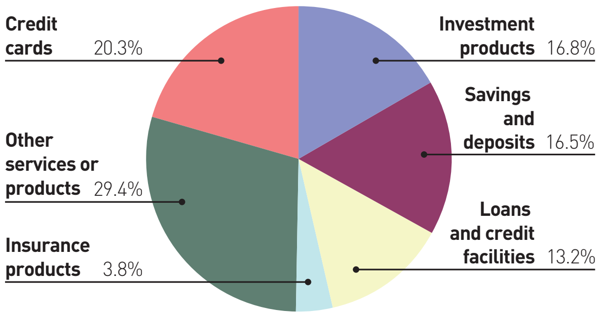


Chart 3 **Types of service or product concerned in banking complaints received by the HKMA**



Lehman-Brothers-related investigation

The HKMA and the SFC reached settlement agreements with two more banks in relation to their distribution of Lehman-Brothers-related equity-linked notes and market-linked notes, entitling 3,458 eligible customers to repurchase offers from the banks.

By the end of the year, over 99.6% of the 21,835 complaints received by the HKMA on Lehman-Brothers-related products had been dealt with. In particular, over 86.6% had been resolved by settlement agreements under section 201 of the Securities and Futures Ordinance (15,756 cases) or through the banks' enhanced complaint-handling procedures (3,174 cases). Investigation of the remaining 72 Lehman-Brothers-related complaints was underway at the end of the year. The majority of these cases were received in 2011.

Non-Lehman-Brothers-related investigations

The HKMA completed the handling and assessment of 414 complaints involving products not related to Lehman Brothers. Among them, 25 were opened for investigation. Investigations of 77 cases were completed by the end of the year. The MA took disciplinary action under section 58A of the Banking Ordinance to suspend the particulars of two Relevant Individuals from the HKMA's register for one month. On the basis of the HKMA's recommendations, the SFC banned a former Relevant Individual from re-entering the industry for two years by exercising its disciplinary power under the SFO.

Deposit Protection Scheme

The enhanced Deposit Protection Scheme (DPS) providing a higher protection limit of HK$500,000 per depositor per bank came into operation on 1 January following the expiry of the Government's Full Deposit Guarantee on 31 December 2010. In addition to the increase in the protection limit, coverage of the DPS has been expanded to include deposits pledged as security for banking services. Measures to make the determination of compensation payments more efficient also became effective at the beginning of the year.

The enhanced DPS Representation Rules, which require Scheme members to make proper representations on their DPS membership and the protection status of their financial products, also took effect at the beginning of 2011. Various mechanisms were applied to monitor compliance, including a requirement for Scheme members to conduct a self-assessment of their compliance for the first half of 2011. In addition, in July the HKMA began a series of on-site examinations to ascertain the level of Scheme members' compliance with the Rules in greater detail. So far, the results have been generally satisfactory and no significant incidence of non-compliance was identified.

The FSB launched a peer review of FSB member jurisdictions' deposit insurance schemes, using the *Core Principles for Effective Deposit Insurance Systems* (Core Principles) issued jointly by the Basel Committee and the International Association of Deposit Insurers as the benchmark. The review also seeks to draw lessons from members' experience of the effectiveness of reforms implemented in response to the recent financial crisis. Taking into account the results of the peer review, the design of the DPS will be thoroughly reviewed against the Core Principles in 2012.

Oversight of clearing and settlements systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO) empowers the MA to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre. Its purpose is to promote the general safety and efficiency of the designated systems: the Central Moneymarkets Unit (CMU), Hong Kong dollar Clearing House Automated Transfer System (CHATS), US dollar CHATS, Euro CHATS, Renminbi CHATS and the Continuous Linked Settlement (CLS) System. Except for the CLS System, the HKMA oversees the designated systems through off-site reviews, continuous monitoring, on-site examinations and meetings with management.

All designated systems continued to comply with the safety and efficiency requirements under the CSSO in 2011. In addition to meeting CSSO requirements, the systems are encouraged to comply with international standards for payment and settlement. During the year the HKMA assessed the Euro CHATS and US dollar CHATS against the *Core Principles for Systemically Important Payment Systems* issued by the Bank for International Settlements (BIS). The assessments took account of the existing policies regarding payment and settlement systems of the European Central Bank and the US Federal Reserve under the principles for international co-operative oversight. The assessment reports were published to promote transparency.

Co-operative oversight arrangements

The CLS System is operated by CLS Bank, which is primarily regulated by its home supervisor, the US Federal Reserve. The HKMA participates, through the CLS Oversight Committee, in the international co-operative oversight of the CLS System. In 2011 the HKMA participated in various meetings and telephone conferences of the Committee and reviewed documents related to the operations and developments of the CLS

System to ensure that the System continued to meet the safety and efficiency requirements under the CSSO.

The HKMA also co-operates with other central banks in the oversight of foreign currency payment systems in Hong Kong. In particular, co-operative oversight arrangements are maintained with other central banks for payment-versus-payment (PvP) links established between payment and settlement systems in Hong Kong and those in other jurisdictions. Such arrangements exist for the US dollar/Malaysian Ringgit PvP link and the US dollar/Indonesian Rupiah PvP link.

Independent tribunal and committee

An independent Clearing and Settlement Systems Appeals Tribunal was established in 2004 to hear appeals against decisions of the MA on designation and related matters under the CSSO. There has been no appeal since the establishment of the Tribunal.

An independent Process Review Committee reviews processes and procedures adopted by the HKMA in applying standards set under the CSSO to systems in which the HKMA has a legal or beneficial interest. The Committee evaluates the designated systems' compliance with the oversight standards and assesses whether the HKMA has applied the same procedures to all designated systems. The Committee met twice in 2011 and reviewed four regular reports and 24 accompanying oversight activities management reports. The Committee concluded that it was not aware of any case where the HKMA had not duly followed the internal operational procedures, or where the HKMA had not been procedurally fair in carrying out its oversight activities. Under its terms of reference, the Committee submitted its annual report to the Financial Secretary, which is available on the HKMA website.

Informal oversight of retail payment systems

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

The HKMA monitors the compliance of Octopus Cards Limited (OCL) with the Code of Practice for Multi-purpose Stored Value Card Operation issued by OCL and endorsed by the HKMA in 2005. In 2011 OCL completed its sixth annual self-assessment against the Code and reported its full compliance.

The Code of Practice for Payment Card Scheme Operators, issued by eight credit and debit card scheme operators and endorsed by the HKMA in 2006, sets out the principles covering operational reliability, data and network security, and the efficiency and transparency of payment card operations in Hong Kong. The HKMA monitors the operators' compliance with the Code and operators are required to perform an annual self-assessment and report to the HKMA any incident which may have material adverse impact on Hong Kong cardholders. In the fourth annual self-assessment report covering 2010, the eight card scheme operators reported full compliance with the Code. Since June 2010, the HKMA has published quarterly aggregate payment card data collected from the card operators to promote transparency of the payment card industry.

Licensing

At the end of 2011, Hong Kong had 152 licensed banks, 20 restricted licence banks, 26 deposit-taking companies and 15 approved money brokers. During the year the HKMA granted seven bank licences and one restricted bank licence to eight foreign banks, and upgraded one overseas restricted licence bank to a licensed bank. Two licensed banks, two restricted licence banks (including the one which was upgraded to a licensed bank) and one money broker revoked their authorization during the year.

The HKMA released a consultation paper on the review of the market entry criteria for banks seeking authorization in Hong Kong in January 2012. The aim of the review is to introduce refinements to the criteria so as to bring them more in line with international practices and to ensure that they do not put Hong Kong at a disadvantage compared with other financial centres.

International co-operation

The HKMA continues to participate in various international and regional forums for banking supervisors and is currently a member of both the Basel Committee and its governing body, the Group of Governors and Heads of Supervision. The HKMA also participates in various Basel Committee working groups, including the Standards Implementation Group, the Working Group on Liquidity, the Definition of Capital Sub-Group and the QIS Working Group. The Basel Committee established a number of new working groups in 2011. Among these, the HKMA is a member of the Core Principles Group, the Large Exposures Group, and the Capital Planning Workstream. The HKMA also participates in the newly established joint BCBS-IOSCO-CPSS-CGFS Working Group on Margining Requirements.

The HKMA is a member of the FSB Standing Committees on Supervisory and Regulatory Cooperation and on Assessment of Vulnerabilities, and participates in the former's Cross-border Crisis Management Working Group and the newly established Mortgage Underwriting Principles Working Group. Regionally, the HKMA is a member of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and continues to be the leader of the Interest Group on Liquidity under the EMEAP Working Group on Banking Supervision. The HKMA is also a member of the South East Asia, New Zealand and Australia Forum of Banking Supervisors.

In addition, the HKMA participates in committees and working groups under the BIS and EMEAP related to payment systems oversight. It is a member of the joint working group under the BIS Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) and participated in the review of the existing standards for financial market infrastructures (large-value payment systems, securities settlement systems and central counterparties). In March the CPSS-IOSCO issued for market consultation a report "Principles for Financial Market Infrastructures", which contains a comprehensive set of principles designed to apply to all systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories. The HKMA performed an initial assessment in mid-2011 on how well the local designated systems would meet the proposed new standards and provided its comments to the BIS, and continued to discuss with the settlement institutions and systems operators of the designated systems areas where further enhancement may be needed to meet the new requirements. During the year the HKMA met with the European Central Bank and the UK Financial Services Authority to discuss oversight issues of common interest.

PLANS FOR 2012 AND BEYOND

Supervisory focus

Credit growth

While growth in bank lending showed some moderation in the second half of 2011, it remains a key area of supervisory attention because of the potential impact it may have on the credit quality, liquidity and other risk management aspects of AIs. Given the uncertainties in the global economic outlook, the HKMA will continue its monitoring and surveillance of AIs' asset quality, funding strategies and other areas of prudential concern and may consider adopting further supervisory measures to address any further build-up of risks to banking stability. The HKMA's internal stress tests are also being enhanced to take into account the latest developments.

Credit risk management and asset quality

The outlook for the global economy remains uncertain given the increased volatility in financial markets and the European sovereign debt crisis. The HKMA will continue to enhance its prudential supervision on AIs to ensure that they remain vigilant in their conduct of banking business through on-going on-site examination, off-site prudential supervision and enhanced communication and cross-border co-operation with overseas supervisors. The HKMA will conduct thematic examinations to ensure AIs have exercised extra caution in their lending business and maintained a high degree of vigilance in their underwriting standards and adequate provisioning, and have effective contingency funding plans.

For European banks affected by the sovereign debt crisis and with a presence in Hong Kong, the HKMA will also continue to monitor market developments including the compliance of European banks with Europe's new capital requirements by the end of June 2012, and keep track of the potential impact of recapitalisation and deleveraging of European banks on Hong Kong.

Supervision of technology risk

A round of thematic examinations is planned for 2012 to assess AIs' security controls over transaction services conducted through Internet banking, mobile banking and phone banking services, as well as controls over IT problems and change management processes.

The HKMA will monitor the implementation of the chip-based ATM security controls and will work with the industry to promote public awareness of the new measures.

Supervision of operational risk

The HKMA will continue to identify and address emerging operational risks of AIs through on-site examinations and off-site reviews. To ensure that material operational losses incurred by business lines are properly captured and monitored by AIs, the HKMA plans to conduct in 2012 a round of thematic examinations to review their operational loss data collection processes.

Supervision of securities, investment products, insurance and MPF-related businesses

The HKMA will:

- work closely with the SFC and the banking industry to enhance the regulatory regime governing the sale of investment products, while striving to maintain an appropriate balance between investor protection and market development

- continue to conduct off-site and on-site surveillance of AIs' business conduct in respect of the sales of securities, other investment and insurance products

- continue to co-operate with the FSTB and other financial regulators in enhancing and implementing the regulatory regimes for insurance and MPF-related intermediary activities in Hong Kong.

Supervision of treasury activities

The HKMA will continue to give priority and resources to on-site examinations of AIs' treasury and derivative activities and surveillance of potentially important emerging risks. Given the increasing importance of firm-wide stress testing and liquidity risk management under the current regulatory and market conditions, the treasury examinations will cover these two areas for selected AIs where necessary to enhance supervision in these areas.

Mainland-related business

With the rapid expansion of the Mainland operations of Hong Kong banks, the HKMA will strengthen its surveillance to ensure that the associated risks are assessed and managed appropriately. In addition to more frequent data collection for off-site review and increasing on-site examinations of Mainland operations, the HKMA will step up supervising communication with the China Banking Regulatory Commission to further enhance home-host supervisory co-operation.

Against the background of increasing Mainland-related business conducted by AIs, the need to ensure compliance with legal and regulatory requirements on the Mainland and in Hong Kong will be a key focus in the HKMA's on-site examinations. Consideration will also be given to collecting more frequent prudential data for analytical purposes. In addition, with the substantial development of renminbi banking business during 2011, the HKMA will conduct intensive on-site examinations on AIs' compliance with the HKMA's requirements and will step up monitoring of how AIs manage the risks arising from this line of business.

Prevention of money laundering and terrorist financing

The HKMA will continue its co-operation with the FSTB and other financial regulators to ensure the smooth implementation of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance on 1 April 2012. The HKMA will also work closely with the banking industry to ensure a smooth transition to the regime under the Ordinance.

The Financial Action Task Force will conclude its revision of the prevailing international anti-money laundering standards in 2012. Following promulgation of the revised international anti-money laundering standards, the HKMA will assist the FSTB to review and where necessary implement the changes in Hong Kong.

The HKMA will continue to conduct institution-specific and thematic examinations to ensure AIs remain vigilant against money laundering and terrorist financing.

Enhancement to management information system

The project to revamp the internal management information system to process data collected from AIs will continue until 2013. In 2012 detailed data and system requirements will be determined and the relevant enhancements will be worked out.

Co-operation with supervisors outside Hong Kong

The HKMA will continue its communication and co-operation with supervisors outside Hong Kong and actively participate in college-of-supervisors meetings organised by the home supervisors of banking groups with significant operations in Hong Kong and participate in crisis management groups to shape the policy outcomes. This will facilitate improved supervision of the local operations of banks that are regarded as Systemically Important Financial Institutions. Efforts will also continue to ensure the timely sharing of bank-specific prudential information and other issues of mutual interest, such as European banks' latest financial condition and implementation of recapitalisation plans.

Basel II

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

The Banking (Capital) (Amendment) Rules 2011 and Banking (Disclosure) (Amendment) Rules 2011, which incorporate the Basel Committee's July 2009 enhancements to the Basel II framework, came into effect on 1 January 2012. The HKMA will continue to assist the industry in complying with these Rules through the development of supervisory guidance on aspects of their application. The HKMA will continue to monitor individual AIs' capital positions as part of its on-going supervisory assessment of the impact of the Rules.

Implementation of advanced approaches

The HKMA will conduct model validations and reviews against the requirements in the revised Banking (Capital) Rules, for those AIs that seek to use, or to continue using, the IMM approach for market risk on and after 1 January 2012.

Under Basel II, there are three methods for banks to calculate capital requirements in respect of their counterparty credit risk (CCR) exposures arising from OTC derivatives transactions: the current exposure method (CEM); the standardised method (SM); and the IMM subject to prior supervisory approval. In the initial phase of Basel II implementation in Hong Kong, only the CEM was introduced, given AIs' limited appetite and state of readiness for the adoption of the more advanced methods (the SM and IMM). Based on the results of two follow-up surveys in 2007 and 2008, the HKMA concluded that the strengthening of supervisory guidance on the systems and control standards for CCR management should take precedence over the introduction of the more advanced CCR calculation methods. As a result, a supervisory guideline "Counterparty Credit Risk Management" was issued in June 2009. Subsequently, in developing its proposals for implementing the strengthened CCR requirements under Basel III (which are particularly relevant to the IMM), the HKMA has revisited the issue and proposes to make the IMM available in Hong Kong (there remains little apparent demand for the SM). The HKMA therefore intends to implement the IMM on 1 January 2013, along with the CCR enhancements under Basel III.

Capital adequacy assessment process

The thematic reviews of selected AIs to identify sound practices for conducting CAAP will continue in 2012. After the reviews, the HKMA plans to share these sound practices, as well as any common inadequacies observed, with AIs.

Revision of liquidity supervisory framework

The HKMA's focus in 2012 will be on monitoring AIs' progress in complying with the standards in the guideline "Sound Systems and Controls for Liquidity Risk Management" issued in April 2011. This will include a review of AIs' deliverables in the areas of enhanced liquidity risk management policies, liquidity stress-testing, and cash-flow approaches to the management of liquidity risk.

The HKMA will also begin the preparatory work to enhance the existing liquidity reporting framework so that it can support the HKMA's plans to implement the Basel III liquidity standards and enable the HKMA to make more use of liquidity monitoring tools and metrics, thereby facilitating supervisory monitoring of AIs' liquidity risk profiles and positions.

Basel III

Capital standards

Legislative amendments

The HKMA has started to consult the banking industry on its policy proposals which will form the basis for rule making under the enabling provisions introduced by the Banking (Amendment) Ordinance 2012 gazetted on 9 March 2012. The definition of capital, minimum risk-weighted capital ratios, and enhanced counterparty credit risk (CCR) capital requirements will be the first set of standards to take effect from 1 January 2013 according to the Basel Committee's timetable. The industry will therefore be consulted in the second half of 2012 on the text of the draft amendments to the Banking (Capital) Rules and Banking (Disclosure) Rules to bring these requirements into effect, with a view to submitting the draft amendment rules to the Legislative Council for negative vetting in the fourth quarter of 2012.

Industry consultations

The first Basel III consultative package issued in January 2012 covers proposals in relation to the definition of capital, the CCR framework and Pillar 2:

- *Definition of capital:* As a general principle, the HKMA proposes to follow the Basel III requirements, except in certain areas where there are strong reasons to retain an existing policy or practice. Areas which require consideration from this perspective include the capital treatment of unrealised gains arising from the fair valuation of assets in the banking book (such as securities classified as "available for sale" or "designated at fair value" and properties held for investment or own-use); the treatment of collective impairment allowance and regulatory reserve; and certain regulatory adjustments or deductions to the capital base (such as capital holdings in other financial entities)

- *Counterparty credit risk framework:* The HKMA proposes to implement both the strengthened CCR requirements (including the new capital charge for credit valuation adjustments) and the Basel III central counterparty framework

- *Pillar 2:* The HKMA proposes to retain substantially its existing approach to Pillar 2 and outlines in the consultation package the options for integrating Pillar 2 capital requirements into the Basel III framework. A separate review will be undertaken to identify any overlap between risk factors considered within the Pillar 2 framework and the new Basel III capital requirements (particularly the new capital buffers), in order to avoid any "double-charging" of regulatory capital. The HKMA will also continue to monitor international developments, including the Pillar 2 approaches adopted by other major supervisors, and will assess their implications for Hong Kong. The HKMA intends to finalise its approach to the application of Pillar 2 under Basel III and update the relevant supervisory guideline "Supervisory Review Process" by the end of 2012.

Basel III (continued)

Consultation on other aspects of the Basel III capital standards (such as disclosure requirements relating to constituent elements of capital base) will be conducted in subsequent phases.

Liquidity standards

In 2012 the HKMA will continue with the development of its policy proposals for implementing the Basel III liquidity standards in Hong Kong, taking into account international developments and the implementation approaches of major overseas regulators, and start the preparatory work for the rule-making process under the Banking (Amendment) Ordinance 2012.

It is envisaged that consultation on the liquidity implementation proposals will begin in 2012, as a basis for drafting a set of Banking (Liquidity) Rules during 2013 and 2014 (in anticipation of the Basel Committee's timetable which provides for the liquidity coverage ratio to become effective from 2015 and the net stable funding ratio from 2018). Thereafter, attention will turn to development of the accompanying regulatory reporting requirements, monitoring tools, and supplementary codes of practice and guidelines. The legislative process for the Banking (Liquidity) Rules in respect of the liquidity coverage ratio is targeted to be completed within 2014 while that in respect of the net stable funding ratio is targeted to be completed within 2017.

The HKMA believes that continued dialogue with the industry is crucial for the smooth and effective implementation of the new liquidity standards and will continue to seek industry input on market practices and issues affecting implementation.

Transitional arrangements

During the observation and supervisory monitoring periods set by the Basel Committee as part of the transitional arrangements for implementation of Basel III, the HKMA will continue contributing data, collected from the local banking sector, to the Basel Committee's QIS Working Group. The HKMA will also continue with its own monitoring process for the local banking sector, formalising the local QIS reporting arrangements for this purpose, until the new requirements are formally implemented. The main objective underlying these reporting arrangements is the monitoring of AIs' readiness to comply with the new standards. They are not a tool for de facto accelerated implementation of the standards.

Systemically important banks

The work related to systemically important banks (SIBs) will continue, particularly on two fronts: the extension of the global systemically important banks (G-SIBs) framework to domestic SIBs (D-SIBs) and the establishment of a Peer Review Council within the Financial Stability Board (FSB) to ensure the full and consistent implementation of measures for systemically important financial institutions across jurisdictions. As Hong Kong plays host to all of the 29 G-SIBs identified to date by the Basel Committee and the FSB, the HKMA will actively participate in the shaping of policies in these areas, and enhance co-operation with international organisations and home supervisors in regulating G-SIBs.

Another key area of focus in respect of systemically important banks (both G-SIBs and D-SIBs) is the development of a policy framework for drawing up recovery and resolution plans (RRPs) (often referred to as "living-wills") to promote the resolvability of such institutions as part of the overall supervisory process. The requirement for robust and credible RRPs is one of the *Key Attributes of Effective Resolution Regimes for Financial Institutions* identified by the FSB. The HKMA intends to consult the industry on proposals for drawing up RRPs for systemically important banks during 2012.

Development of supervisory policies

Corporate governance

The HKMA intends to finalise the revisions to its supervisory guideline "Corporate Governance of Locally Incorporated Authorized Institutions" in the first half of 2012, taking into account the comments received in the industry consultation. Since most of the major Hong Kong-incorporated AIs are listed on the Stock Exchange of Hong Kong, the HKMA, in finalising the revised guideline, will have regard to the results of the Stock Exchange's recent consultation exercise on proposed changes to its *Code on Corporate Governance Practices* and certain of the Listing Rules relating to corporate governance.

Credit risk transfer

The HKMA intends to issue supervisory guidance on credit risk transfer for industry consultation in 2012. This guidance will incorporate recommendations and best practices proposed by international standard setters (including the Financial Stability Board, the Joint Forum[5], the Basel Committee and the International Organization of Securities Commissions) in the light of lessons from the global financial crisis, and will seek to promote sound risk management for credit risk transfer activities conducted by AIs. The new guideline is intended to supersede the existing supervisory guideline "Credit Derivatives".

Guideline on the application of the Banking (Disclosure) Rules

Amendments to the Banking (Disclosure) Rules to incorporate the July 2009 enhancements to the Basel II disclosure requirements came into effect on 1 January 2012. To facilitate AIs' compliance with the new disclosure requirements, the HKMA intends during 2012 to update its existing "Guideline on the Application of the Banking (Disclosure) Rules".

Market risk management

The HKMA also intends to issue a new supervisory guideline on market risk management to help strengthen AIs' management of market risk, taking into account the lessons of the global financial crisis and the latest recommendations and best practices issued by international organisations. A consultation document is expected to be issued to the industry associations in the second half of 2012.

Stress testing

Having considered the industry's comments on the draft revised supervisory guideline "Stress-testing", the HKMA issued a further revised draft for industry consultation early this year. The HKMA will endeavour to finalise the revised guideline in the first half of 2012 after addressing any further comments from the industry.

Supervisory review process

The HKMA plans to complete its review of the Pillar 2 framework in the first half of 2012 to cater for Basel III implementation. Thereafter, the industry will be consulted on the changes proposed to the existing framework, with a view to updating the supervisory guideline "Supervisory Review Process" by the end of 2012.

Guideline on over-the-counter derivative market reforms

When margining standards for non-centrally cleared derivatives are agreed internationally, the HKMA will

[5] The Joint Forum is under the aegis of the Basel Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

Development of supervisory policies (continued)

update its prudential framework for AIs as appropriate to align with the new international standards.

Once the over-the-counter (OTC) derivatives market regulatory regime is finalised in Hong Kong, the HKMA intends to issue a supervisory guideline to outline the key requirements of the new regime and the HKMA's approach to supervising AIs' OTC derivatives activities. The draft guideline is expected to be released for industry consultation in the second half of 2012.

Use of internal models approach to calculate market risk

The supervisory guideline "Use of Internal Models Approach to Calculate Market Risk" is being updated to align with the enhancements to the IMM approach for market risk set out in the Banking (Capital) (Amendment) Rules 2011. A draft revised guideline was issued for industry consultation in March 2012.

Accounting and disclosure standards

The HKMA will monitor accounting developments emanating from the IASB work plan to enhance global accounting standards (particularly in relation to a new impairment accounting standard) and will maintain its regular dialogue with the HKICPA and the banking industry on these developments.

International co-operation

The HKMA will continue participating in the on-going work of the Basel Committee and the FSB, including through participation in the thematic peer reviews on risk governance and on resolution regimes which the FSB proposes to conduct in 2012.

Consumer protection

The HKMA will continue to work to improve the standards of banking practices through participation in the Code of Banking Practice Committee. It will also continue monitoring AIs' compliance with the Code through regular self-assessments, on-site examinations and the handling of complaints about products and services provided by AIs.

In relation to the proposed Investor Education Council and Financial Dispute Resolution Centre, the HKMA will continue to work with the FSTB, the SFC and the industry to prepare for their establishment and operation.

The HKMA will jointly host with the OECD and the SFC a regional seminar on financial consumer protection and education in Hong Kong in the second half of 2012.

Credit data sharing

The HKMA will review AIs' implementation of the positive mortgage data sharing scheme through on-site examinations on their compliance with the regulatory requirements.

During the review leading to the expansion of credit data sharing to include positive mortgage data, the Privacy Commissioner for Personal Data (PCPD) required that a threshold be set for non-mortgage-related credit facilities, above which AIs would be allowed to access the number of mortgages held by a customer when considering the grant, renewal or review of non-mortgage-related credit facilities. The HKMA will work with the industry to set an appropriate threshold, for which the PCPD's endorsement will be sought.

Enforcement

Following the completion of the vast majority of the Lehman-Brothers-related complaints, the remaining work of the HKMA in that regard is mainly to:

- continue to handle individual cases excluded by the settlement schemes under section 201 of the Securities and Futures Ordinance and cases of customers who rejected the settlement offers under the schemes

- investigate the 72 outstanding cases

- handle enquiries from customers whose cases were closed.

On the other hand, the HKMA will accelerate the handling of 1,197 outstanding non-Lehman-Brothers-related complaints, the progress of which has been affected by the need to accord priority to Lehman-Brothers-related complaints in the past few years.

The HKMA supervisory guideline "Complaint Handling Procedures" will be revised to take account of recent developments.

Under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance which took effect on 1 April 2012, the HKMA is the relevant authority for conducting investigations and taking disciplinary action under the Ordinance in respect of AIs.

Under legislative proposals to enhance regulation of the sale and marketing of insurance products and MPF schemes, the HKMA is expected to take an active role in enforcement and will continue to work closely with the FSTB and the relevant financial regulators on the related legislation and standard setting.

Deposit protection

The HKMA will continue to assist the Hong Kong Deposit Protection Board in implementing and operating the enhanced DPS. As the Global Financial Crisis continues with intensified concerns on the European sovereign debt problems, it is important that the Board stands ready to execute a payout effectively and efficiently at any time should there be a bank failure. Efforts will therefore be made to further upgrade and test the payout readiness of the Board. Simulation tests, compliance reviews and payout rehearsals will continue to be conducted by the Board to ensure its readiness to handle a payout. In respect of monitoring Scheme members' compliance with the representation requirements, the annual self-assessment review will continue and the HKMA will assist the Board to conduct on-site examinations. Further advertising campaigns will be held in 2012 to maintain the public's awareness of the DPS and new initiatives to carry out public education and outreach campaigns to reach specific target groups will be explored.

Taking into account the results of the Peer Review on Deposit Insurance Systems, a thorough review of the design of the existing DPS in Hong Kong against the Core Principles will be undertaken using the Methodology for Compliance Assessment. The objective is to evaluate the standard of compliance with the Core Principles and identify areas that may require further enhancements.

Payment systems oversight

As the overseer of designated systems under the CSSO, the HKMA will continue to be involved in promoting and ensuring the safety and efficiency of these systems; and will continue to monitor the performance of the operators of retail payment systems under their self-regulatory codes of practice, keep abreast of global trends and improve the current regime where necessary.

The BIS is expected to finalise and publish *The Principles for Financial Market Infrastructures* in 2012. The HKMA will work with the system operators and settlement institutions of the designated systems on how best to comply with the new international standards.

A local trade repository, which provides a central registry for collecting and maintaining records of OTC derivatives transactions, will be set up in Hong Kong as part of the CMU service in 2012. The HKMA will oversee the local trade repository and develop an oversight regime, taking into account the international standards and oversight practices, which are still evolving.

International Financial Centre

Hong Kong strengthened its position as an international financial centre in 2011 despite the weakening global economic recovery and sharp rise in financial market tensions amid the deepening European sovereign debt crisis. Renminbi business grew rapidly, enabling Hong Kong to develop as the premier offshore renminbi business centre. The HKMA continued to participate actively in international discussions on reforms to improve the resilience of the global financial system, and has strengthened regional surveillance and co-operation to promote financial stability. Hong Kong's robust fiscal performance and the resilience of its financial system were recognised by credit rating agency Standard & Poor's, which affirmed Hong Kong's top-rated AAA rating.

OVERVIEW

Global economic and financial market conditions deteriorated rapidly in the second half of 2011, as the escalating debt crisis in the peripheral economies of the euro area triggered concerns about fiscal sustainability of core euro area economies and the health of European banks. While Asian economies remained resilient amidst heightened external uncertainties, they were facing increasing downside risks given the global economic slowdown and continued turbulence in the global financial markets. Closer international and regional co-operation to step up market surveillance and co-ordinate policy responses has been particularly crucial. Meanwhile, international efforts continued to follow through with the financial regulatory reform agenda set by the Group of Twenty (G20)[1] after the global financial crisis to improve the resilience of the global financial system.

The HKMA actively participates in international discussions and exchanges views with the international community on issues of significance to the global and regional financial stability. In 2011 it continued to co-ordinate the macro-surveillance work for the Monetary and Financial Stability Committee established under the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).[2] The HKMA also took part in meetings and forums of multilateral organisations, notably the Financial Stability Board (FSB)[3], which plays a key role in the reform of the international financial system. In addition, the HKMA continued to work closely with ASEAN+3[4] authorities on various implementation work relating to the Chiang Mai Initiative Multilateralisation (CMIM)[5], including the establishment of the ASEAN+3 Macroeconomic Research Office – an independent regional surveillance unit to monitor and analyse regional economies and support CMIM decision making.

There was remarkable progress in the development of Hong Kong as the premier offshore renminbi business centre. Following close discussions with the Mainland authorities, further measures were introduced to promote the use and circulation of renminbi funds between the onshore and offshore markets. Renminbi financial activities expanded significantly, with Hong Kong becoming a global hub for renminbi trade settlement, financing and asset management, supporting overseas corporates and financial institutions in conducting offshore renminbi businesses.

The safe and efficient operation and the continued development of the financial infrastructure in Hong Kong played a significant role in reinforcing the competitive edge of Hong Kong as an international financial centre. During the year different components of the financial infrastructure operated smoothly. A series of enhancements was made to the renminbi Real Time Gross Settlement (RTGS) system. Leveraging on the renminbi clearing platform, Hong Kong has developed into the premier offshore renminbi business centre. The HKMA continued to make progress on the development of a local trade repository for over-the-counter (OTC) derivatives trades. At the cross-border level, there has been further progress in launching the Pilot Platform and add-on services to facilitate cross-border transactions and collateral management in bonds. The HKMA has also conducted a review on retail payment with several recommendations to improve the efficiency of the retail payment infrastructure in Hong Kong.

1 The G20 was established in 1999, bringing together the finance ministers and central bank governors of industrialised and emerging economies to facilitate international economic policy co-operation. Member economies include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Republic of Korea, Russia, Saudi Arabia, South Africa, Turkey, the UK, the US and the European Union. In 2008, amid the global financial crisis, G20 leaders held their first meeting in Washington D.C. Since then, G20 leaders have convened on a regular basis.

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

3 The FSB was established in April 2009 as the successor to the Financial Stability Forum to address vulnerabilities in global financial systems, and to develop and implement effective regulatory, supervisory and other policies in the interest of financial stability. Its membership comprises senior representatives of national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance), international financial institutions, standard-setting bodies, and committees of central bank experts.

4 ASEAN+3 comprises the 10 ASEAN member countries (Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam), together with China, Japan and Korea.

5 With access of up to US$120 billion, the CMIM is a regional joint-defence mechanism which provides short-term US dollar support to participants facing liquidity shortages. The facility was established under the aegis of ASEAN+3 and became effective in March 2010.

International Financial Centre

REVIEW OF 2011

International and regional co-operation

With increasing globalisation, and closer economic and financial integration in Asia, the HKMA organises and participates in international and regional initiatives and discussions on a wide range of issues. It attended meetings of the Asia-Pacific Economic Co-operation (APEC), the FSB and the Bank for International Settlements (BIS). Much of the work of the international financial community focused on reinvigorating economic growth and ensuring financial stability amid the deepening European debt crisis, while continuing to push forward efforts to strengthen and reform the international financial system. Significant progress has been achieved in implementing the global financial regulatory reforms, led principally by the G20. Hong Kong is involved in implementing the G20's initiatives and recommendations through different channels, including the HKMA's participation in the FSB Plenary, Regional Consultative Group for Asia, and Standing Committees on Assessment of Vulnerabilities and on Supervisory and Regulatory Co-operation.

In contributing to the reform of the international financial system, the HKMA is pursuing the implementation in Hong Kong of the relevant recommendations and best practices that are appropriate to local circumstances. Additional information on the HKMA's role in international co-operation can be found in the Chapter on Banking Stability.

Promoting monetary and financial stability in Asia

The HKMA continued to participate actively in the activities of EMEAP to promote regional co-operation. As co-ordinator of the macro-surveillance work for the EMEAP Monetary and Financial Stability Committee, the HKMA conducted analyses and prepared the Committee's half-yearly Macro-Monitoring Report to assess the region's risks and vulnerabilities, in particular those associated with the over-heating pressures in the first half of the year and the rising risks to financial stability amid the worsening European sovereign debt crisis later in the year. The HKMA communicated closely with regional counterparts, including fellow EMEAP members, on issues of common interest such as implications of the international financial regulatory reforms for the region and raised, where appropriate, the collective views of the region to contribute to the international discussions.

The HKMA co-hosted the Working Party on Monetary Policy in Asia with the BIS in June 2011, focusing on topical issues of great interest to policymakers in the region such as capital flows management and the effectiveness of macro-prudential tools in achieving financial stability.

The HKMA continued to work closely with ASEAN+3 authorities on the implementation work relating to CMIM. In April 2011 the ASEAN+3 Macroeconomic Research Office was established under the CMIM to monitor the macroeconomic and financial soundness of regional economies and facilitate effective decision-making of CMIM participants.

As one of the deputy chairs of the EMEAP Working Group on Payment and Settlement Systems, the HKMA has been working closely with the People's Bank of China (PBoC) and Bank Indonesia (the chair and another deputy chair respectively) to co-ordinate the Group's effort in sharing experiences and exchanging information on developments in domestic and cross-border payment and settlement systems. The HKMA is also taking the lead role in its sub-group on cross-border co-operation and development.

The HKMA participated in the Basel Committee on Banking Supervision – Committee on Payment and Settlement Systems Working Group on Intraday Liquidity Management to develop indicators to facilitate supervisors' monitoring of banks' management of their intraday liquidity risks.

Hong Kong's sovereign credit ratings

The HKMA continued to engage international credit rating agencies to present a balanced assessment of Hong Kong's economic and financial developments. These efforts contributed to the affirmation of Hong Kong's sovereign credit ratings by all major credit rating agencies in 2011. Standard & Poor's affirmed Hong Kong's AAA rating, the agency's highest rating category. This reflected the agency's recognition of Hong Kong's above-average growth prospects, strong external position and consistently robust fiscal performance. Moody's Investors Service and Fitch Ratings both affirmed Hong Kong's ratings at Aa1 and AA+ respectively, just one notch below triple-A.

Development of Hong Kong as the offshore renminbi business centre

The HKMA's intensified efforts resulted in remarkable progress in the development of Hong Kong as the offshore renminbi business centre. On the policy front, the support by the Central Government for the development of Hong Kong as the offshore renminbi business centre was enshrined in the National 12th Five-Year Plan promulgated in March 2011. Following the announcement by the Vice-Premier of the State Council Mr Li Keqiang during his visit to Hong Kong in August, a series of new specific measures has been implemented, including expansion of the geographical coverage of the renminbi trade settlement scheme to the entire Mainland that month, promulgation of the administrative arrangements for renminbi foreign direct investments and introduction of the Renminbi Qualified Foreign Institutional Investors (RQFII) scheme. These measures help promote the use and circulation of renminbi funds between the onshore and offshore markets, and provide substantial impetus for the development of the Hong Kong offshore renminbi business centre. Furthermore, in November 2011 the PBoC and the HKMA signed a renewed currency swap agreement for a term of another three years, with its size expanded to RMB400 billion/HK$490 billion. The renewal and expansion of the agreement is crucial in helping the HKMA to provide liquidity, when necessary, to maintain the stability of the offshore renminbi market in Hong Kong.

Governor of the People's Bank of China, Mr Zhou Xiaochuan (left), and the Chief Executive of the HKMA, Mr Norman Chan, sign a renewed currency swap agreement for a term of another three years, with its size expanded to RMB400 billion/HK$490 billion.

International Financial Centre

In 2011 about 8% of Mainland's external trade, or RMB2,081 billion, was settled in renminbi. Meanwhile, Hong Kong has developed into the major offshore renminbi trade settlement centre, with renminbi trade settlement handled by banks in Hong Kong amounted to RMB1,914.9 billion for the year, more than five times the amount for 2010. Supported by the increase in renminbi trade settlement and other financial activities, renminbi deposit grew to RMB588.5 billion at the end of the year.

As the renminbi liquidity pool in Hong Kong continued to expand, renminbi financial intermediary activities became more vibrant. In particular, the development of offshore market of renminbi bonds (also known as "dim sum bonds") in Hong Kong was very encouraging, with bond issuance exceeding RMB100 billion during the year, three times the total of 2010. Renminbi lending business of banks also picked up in 2011. The outstanding renminbi loan amount surged to RMB30.8 billion at the end of 2011, from less than RMB2 billion at the end of 2010.

In addition, apart from serving the needs for renminbi financial services locally, Hong Kong as the offshore renminbi centre has been playing an increasingly important role in supporting overseas corporates and financial institutions in conducting offshore renminbi businesses. At the end of 2011, a total of 187 banks were participating in Hong Kong's renminbi clearing platform, of which 165 were subsidiaries and branches of overseas banks and overseas presence of Mainland banks, representing a payment network covering more than 30 countries in six continents. About 70% of the renminbi deposits were held by corporate customers, of which 15% were from overseas corporates. Moreover, overseas banks have also been using the renminbi correspondent banking services provided by banks in Hong Kong, with the number of such correspondent banking accounts rising from less than 200 to over 900 during the year.

Efforts have also been made to increase the awareness of overseas corporates and financial institutions about expanding use of renminbi and the comprehensive one-stop services that can be offered by Hong Kong's renminbi financial platform, through overseas roadshows and other means, targeting places which have growing trade and investment links with Mainland. In 2011, four overseas roadshows were conducted in Australia, Russia, the UK and Spain to showcase Hong Kong as the premier offshore renminbi business centre. The HKMA will continue to conduct overseas roadshows in the coming year.

Chief Executive of the HKMA, Mr Norman Chan, exchanges thoughts with Deputy Finance Minister of the Russian Federation, Mr Sergey Storchak at the renminbi seminar in Moscow.

To foster co-operation between Hong Kong and London on the development of offshore renminbi business, a joint private-sector forum, facilitated by the HKMA and the UK Treasury, was launched in January 2012. The forum will focus on exploring synergies by enhancing linkages between Hong Kong and London, specifically regarding clearing and settlement systems, market liquidity and the development of new renminbi-denominated financial products. Meanwhile, the HKMA is also working to extend the operating hours of the renminbi RTGS system in Hong Kong to 15 hours, from 8:30 a.m. to 11:30 p.m. (Hong Kong time) by the end of June 2012. This will give financial institutions in London and other financial centres in the European time zone an extended window to settle offshore renminbi payments through the Hong Kong infrastructure.

CEPA

The Eighth Supplement to the Closer Economic Partnership Arrangement (CEPA) was signed in December 2011. Two measures have been added for the banking sector, namely, to allow any Mainland-incorporated subsidiary of Hong Kong banks to engage in the sale and distribution of mutual funds, and to support Mainland banks to make use of Hong Kong's international financial platform to develop their international businesses.

Training

Training programmes are conducted in Hong Kong and the Mainland for officials of the PBoC and the China Banking Regulatory Commission. During the year, 1,407 officials from the Mainland attended 16 courses (3,097 man-days) covering bank accounting management; treasury management; risk management and internal control; human resources management; financial stability; and banking supervision.

The HKMA also provided training on request to other external parties, including a regional course on asset and liability management under the APEC financial regulators' training initiative, and other courses for Mainland commercial banks and enforcement agencies in the region. A total of 193 participants attended these seminars in 2011.

Strengthening Hong Kong as a regional hub

Following the issuance of the White Paper on the Pan-Asian Central Securities Depositories (CSD) Alliance project in June 2010, the HKMA continued to work with Bank Negara Malaysia and Euroclear with an aim of developing a common post-trade processing infrastructure for Asian debt securities. As a result of these concerted efforts, the Pilot Platform for cross-border investment and settlement of debt securities was launched on 30 March 2012. In addition, following the discussions and consensus reached by the Task Force of the Pan-Asian CSD Alliance project, the HKMA commenced development of two add-on services to the Pilot Platform which would facilitate the gradual migration of the Pilot Platform to the Common Platform Model. The two add-on services included cross-border collateral management services and corporate action services. In addition, the HKMA continued to participate in the meetings of Asian Bond Market Initiative co-ordinated by the Asian Development Bank and to contribute to the development of initiatives in regional bond markets.

Leveraging the renminbi advantage

During the year the HKMA attended 56 seminars and 241 marketing calls in various cities on the Mainland, the Asia-Pacific region, Europe, and North America to promote Hong Kong's financial infrastructure, in particular the renminbi RTGS system. As a result, the number of direct participants of the renminbi RTGS system increased from 96 at the end of 2010 to 158 at the end of 2011, of which 33 were overseas banks without presence in Hong Kong. In addition, a total of around RMB1,702.5 billion of trade transactions were settled in Hong Kong's renminbi RTGS system in 2011, with a record monthly turnover of RMB216 billion in December 2011.

Debt market development

Proposed refinements to the Qualifying Debt Instruments Programme, announced by the Financial Secretary in his 2010-11 Budget Speech, were implemented through legislative amendments in March 2011. These refinements will increase the tax concessions for qualifying debt securities under the Programme to further develop the local debt market. Besides assisting in the legislative process, the HKMA conducted briefings for market participants shortly after the implementation of the refinements.

Government Bond Programme

The HKMA continued to co-ordinate the implementation of the Government Bond Programme, consisting of both institutional and retail bond issuances. For the institutional part, six bond tenders totalling $17.5 billion, with tenors ranging from two to 10 years, were completed in 2011. The amount of institutional bonds outstanding at the end of 2011 was $38 billion. The HKMA will maintain close contact with market participants and consider measures to refine the institutional part.

The Financial Secretary announced in the 2011-12 Budget the issuance of up to $10 billion inflation-linked retail bond (iBond), under the Government Bond Programme to help improve retail investors' understanding of the bond market and increase their interest in bond investment. The HKMA was responsible for putting together the issuance, with assistance from the relevant service providers. The iBond was well-received, attracting over 155,000 applications, with application monies exceeding $13 billion. A total of $10 billion iBond was issued to Hong Kong residents on 28 July.

Development of Islamic finance

The HKMA continued to develop Islamic finance in Hong Kong by:

- setting up necessary infrastructure
- enhancing Hong Kong's international linkages with other major Islamic financial markets
- promoting market knowledge of Islamic finance
- encouraging product development.

In particular, one of the major tasks of the HKMA in the area of Islamic finance has been to assist with the preparation of a legislative proposal to amend the Inland Revenue Ordinance and the Stamp Duty Ordinance in Hong Kong with a view to levelling the playing field for issuance and trading of common types of Islamic bonds (sukuk) vis-à-vis their conventional counterparts in terms of tax treatments. The HKMA will continue to engage major market participants in the Islamic finance industry with a view to ensuring that the legislative amendments can meet the latest market needs.

Promotion of asset management business

To promote Hong Kong's asset management industry and reinforce its position as a leading asset management centre, the HKMA, together with other agencies, has been exploring ways to improve the international competitiveness of Hong Kong's financial markets and provide a more favourable tax and regulatory environment for such businesses. In conjunction with other agencies, the HKMA also took part in joint promotional roadshows to New York, London, Geneva, Zurich and Luxembourg to highlight the strengths of Hong Kong's financial platform, focusing on its advantages in the process of the Mainland's gradual financial liberalisation and the wider external use of the renminbi.

The HKMA also visited asset managers in major financial centres, either in small group or on a one-on-one basis, to listen to their business plans in Asia and their views on potential challenges on their operations in Hong Kong. Meetings were held with private banking institutions, pension funds, mutual funds, private equity firms, hedge funds and fund administrators in Beijing, Boston, Edinburgh, Frankfurt, Geneva, Guangzhou, London, Luxembourg, New York, Paris, Shanghai, Shenzhen, Singapore and Zurich.

OTC derivatives market regulation

The HKMA has been working closely with the Financial Services and the Treasury Bureau (FSTB) and the Securities and Futures Commission (SFC) to develop a regulatory regime for the OTC derivatives market in Hong Kong, and has made significant progress. When introduced, the regime will contribute to minimising systemic risk and enhancing transparency in the OTC derivatives market.

In October 2011 the HKMA and the SFC issued a joint consultation paper which detailed how the regime would likely to be cast and invited the public to provide feedback on the proposals. Valuable feedback was received and will be taken into account as appropriate when finalising the legislative details of the regulatory framework. The HKMA continued to engage and regularly update industry through a number of channels, including the OTC Derivatives Market Working Group under the Treasury Markets Association (TMA) and its newly formed sub-groups which address specific regulatory and infrastructural issues.

Meanwhile, the HKMA participated in such international forums as the OTC Derivatives Working Group established under the FSB, OTC Derivatives Regulators' Forum and a Study Group established under the Committee on the Global Financial System (CGFS), contributing to the relevant international initiatives and monitoring closely the international regulatory developments.

Treasury Markets Association

The HKMA maintained its collaborative working relationship with the TMA, providing strategic support as necessary. The TMA strives to raise market professionalism, facilitate market development, encourage the development of new markets and products, and strengthen Hong Kong's ties with the Mainland and with financial centres around the world.

The Association has 1,774 Individual Members and 81 Institutional Members from banks, investment houses, insurance companies, money brokers, financial information services providers, exchanges and large corporations. Under the chairmanship of the HKMA Deputy Chief Executive, Eddie Yue, the TMA achieved pleasing results in 2011:

- **introducing a new professional qualification framework** – the framework covers the entire spectrum of training needs for treasury market participants in different stages of their careers. As part of the new framework, the TMA launched its Level II Graduate Certificate in Treasury Market Management with the School of Professional and Continuing Education of The University of Hong Kong

- **releasing the TMA Code of Conduct and Practice** – comprising international standards with suitable local adaptations, the Code serves as a benchmark for best practices in Hong Kong's treasury markets, setting out the requirements on ethical standards, risk management and dealing practices

- **launching the spot USD/CNY(HK) Fixing** – the reference rate is instrumental in further expanding Hong Kong's offshore renminbi market and the related lines of business

- **continuing efforts to raise market professionalism** – around 50 seminars, workshops and talks were organised for individual members and staff of institutional members

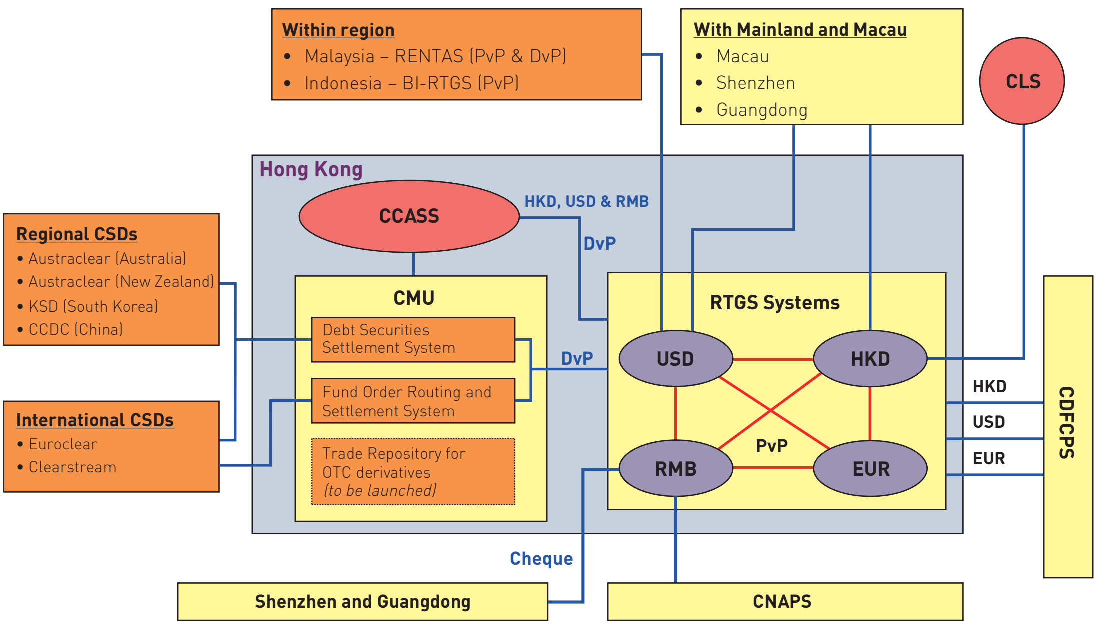
- **co-organising the Treasury Markets Summit with the HKMA** – the Summit was held in Beijing in December with focuses on renminbi internationalisation as well as Hong Kong's role as an asset management centre, bringing together over 200 market participants, regulators and academics.

Hong Kong's financial infrastructure

The HKMA plays a major role in developing Hong Kong's financial infrastructure to reinforce its status as a regional hub for payment and settlement of funds and securities. Over the years, continuous effort and resources have been devoted to building a robust and efficient multi-currency, multi-dimensional platform, with extensive domestic and overseas system linkages (Chart 1).

Key achievements include the establishment of RTGS systems for the Hong Kong dollar, the US dollar, the euro and the renminbi; and developing bilateral links between the local RTGS systems and overseas RTGS systems, and between the Central Moneymarkets Unit (CMU) and regional and international CSDs, such as Euroclear, Clearstream, and the depositories in Australia, New Zealand, South Korea and the Mainland.

Chart 1 Hong Kong's multi-currency payment and settlement infrastructure



BI-RTGS – Bank Indonesia Real Time Gross Settlement (Indonesia's rupiah RTGS system)
CCASS – Central Clearing and Settlement System (settlement system for shares)
CCDC – China Central Depository & Clearing Co., Ltd.
CDFCPS – China's Domestic Foreign Currency Payment System
CLS – Continuous Linked Settlement
CMU – Central Moneymarkets Unit (settlement system for debt securities)
CNAPS – China National Advanced Payment System
KSD – Korean Securities Depository
RENTAS – Real Time Electronic Transfer of Funds and Securities (Malaysia's ringgit RTGS system)

DvP – Delivery-versus-Payment
PvP – Payment-versus-Payment

Hong Kong dollar RTGS system

The Hong Kong dollar Clearing House Automated Transfer System (CHATS), which operates on an RTGS basis, is responsible for clearing all Hong Kong dollar interbank payments, and continues to run smoothly and efficiently. It has a direct link with the CMU to provide both real-time and end-of-day delivery-versus-payment settlement services. Hong Kong Interbank Clearing Limited (HKICL), the operator of the RTGS systems, was established in 1995 and is owned equally by the HKMA and the Hong Kong Association of Banks. In 2011 the HKICL processed a daily average of $539 billion in CHATS transactions (22,682 items), largely unchanged from $545 billion in 2010.

In addition to settling large-value payments, CHATS also handles daily bulk clearings of stock market transactions, credit card transactions, cheques, small-value bulk electronic payment items (EPS, auto-credit and auto-debit transactions) and automatic-teller-machine transfers (Chart 2).

Banks can use their Exchange Fund Bills and Notes (EFBN) to obtain interest-free intraday liquidity through intraday repurchase agreements with the HKMA to settle their interbank payments.

Foreign currency RTGS systems in Hong Kong

The US dollar, euro and renminbi RTGS systems were operating smoothly. The average daily turnover of the renminbi RTGS system increased dramatically in 2011 amid the rapid expansion of renminbi business in Hong Kong. The average daily turnovers and other details of the foreign currency RTGS systems are listed in Charts 3 – 5 and Table 1.

Chart 2 **Hong Kong dollar RTGS system average daily turnover**

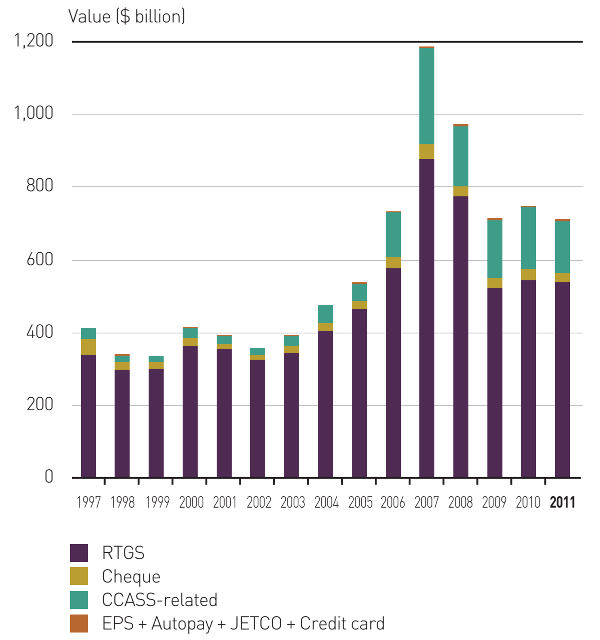


Chart 3 **US dollar RTGS system average daily turnover**

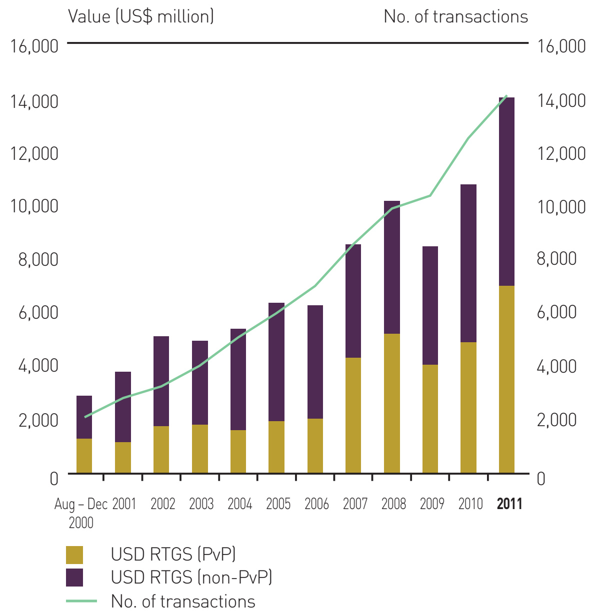


Chart 4 **Euro RTGS system average daily turnover**

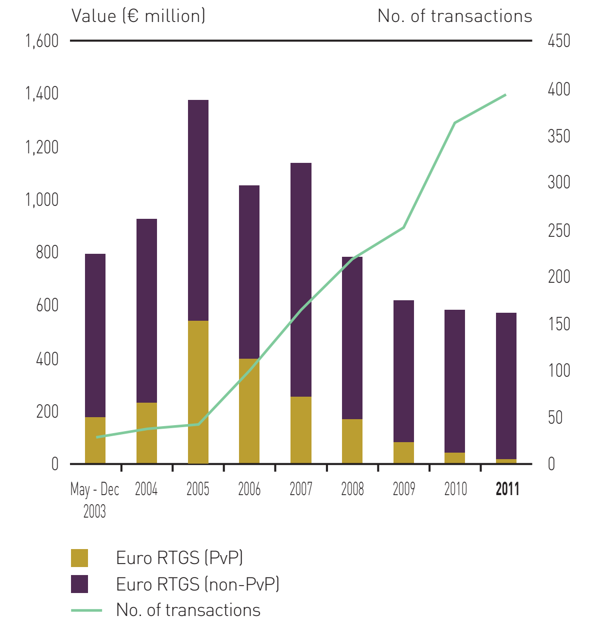


Chart 5 **Renminbi RTGS system average daily turnover**

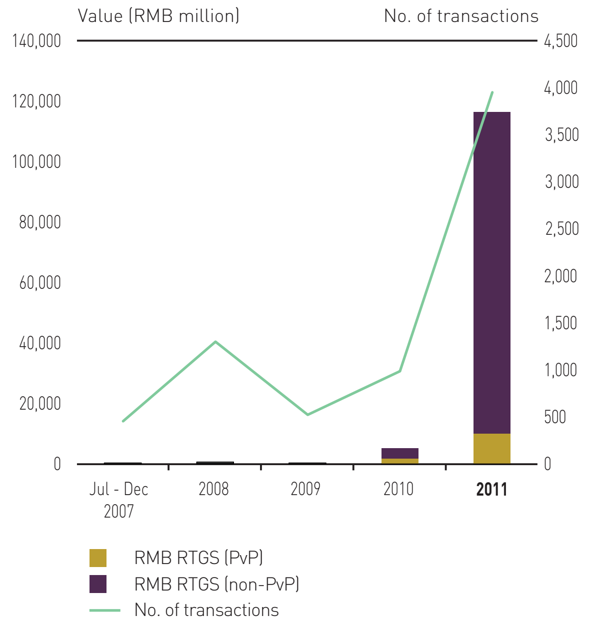


Table 1 **Foreign currency RTGS systems**

RTGS systems	Launch date	Settlement institution or Clearing Bank	Number of participants at the end of 2011	Average daily turnover in 2011	Average daily transactions in 2011
US dollar RTGS system	August 2000	The Hongkong and Shanghai Banking Corporation Limited	Direct: 90 Indirect: 129	US$14.2 billion	14,225
Euro RTGS system	April 2003	Standard Chartered Bank (Hong Kong) Limited	Direct: 33 Indirect: 19	€569.8 million	392
Renminbi RTGS system	June 2007	Bank of China (Hong Kong) Limited	Direct: 158*	RMB114.4 billion	3,888

* Referring to those that have completed the registration of direct membership for the renminbi RTGS system among over 180 participating banks that have signed the Clearing Agreement with the Clearing Bank.

Payment-versus-payment

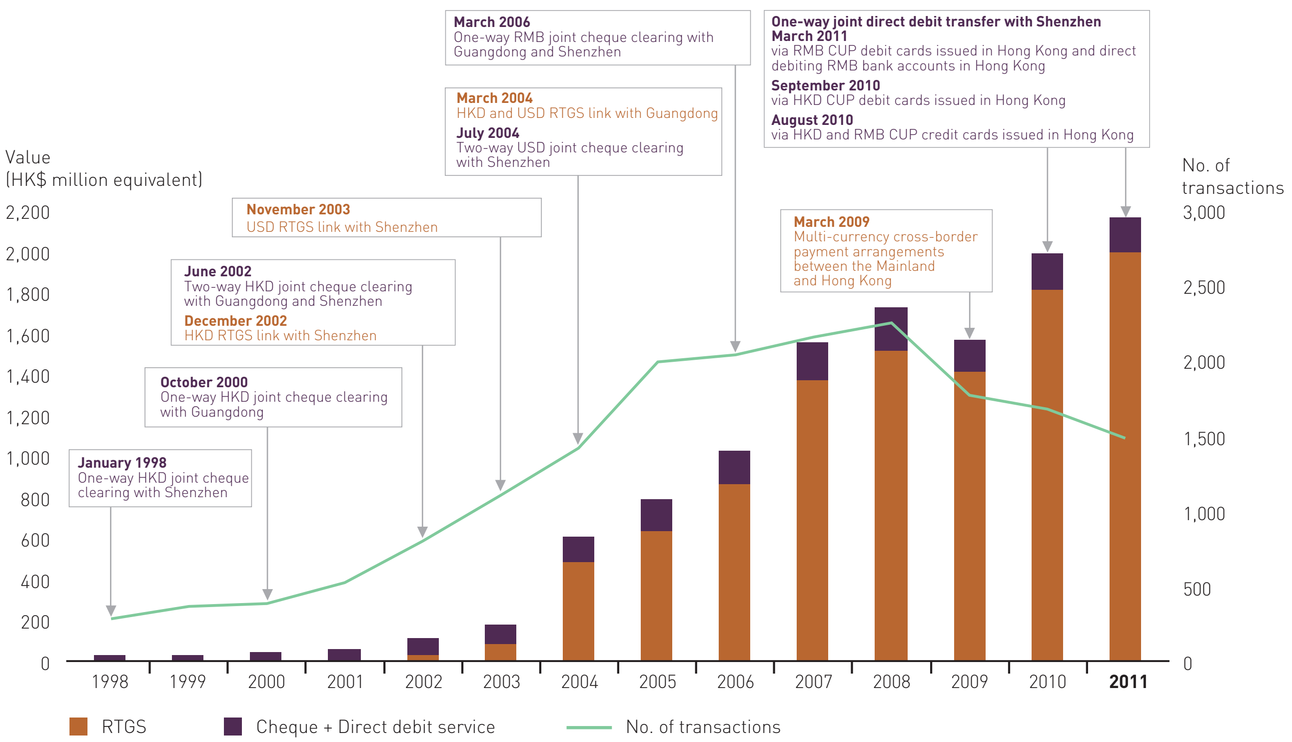
Payment-versus-payment (PvP) is a mechanism for settling a foreign exchange transaction to ensure that payments in the two currencies involved are settled simultaneously. Within Hong Kong, six cross-currency PvP links have been established among the Hong Kong dollar, US dollar, euro and renminbi RTGS systems. Hong Kong's US dollar RTGS system has also established two cross-border PvP links, with Malaysia's ringgit RTGS system in November 2006 and Indonesia's rupiah RTGS system in January 2010. PvP greatly improves settlement efficiency and eliminates settlement risk arising from time lags in settlements and from time-zone differences (known as Herstatt risk). In 2011 the transaction value of Hong Kong dollar, US dollar, euro and renminbi-related PvP transactions amounted to about $4,393 billion, US$1,739 billion, €4 billion and RMB2,423 billion respectively.

Payment links with the Mainland

The HKMA continues to work closely with Mainland authorities in providing efficient cross-border payment links to meet growing demands. The use of these services has risen gradually over the years. In 2011 the average daily turnover handled by the various system links was equivalent to over $2 billion, including the RTGS cross-border links with the Mainland's Domestic Foreign Currency Payment Systems launched in March 2009 (Chart 6).

The RTGS system links with Shenzhen and Guangdong handled more than 20,000 transactions during the year, with a total value equivalent to $469 billion. The system allows cross-border payments in Hong Kong dollar and US dollar to be settled efficiently and safely between banks in Hong Kong and their counterparts in Shenzhen and Guangdong.

Chart 6 Average daily turnover in cross-border arrangements with the Mainland



The two-way joint cheque-clearing facilities processed about 325,000 Hong Kong dollar and US dollar cheques in 2011, with a value equivalent to $40 billion. The facilities shortened the clearing time for cheques drawn on banks in Hong Kong and presented in Shenzhen and Guangdong, and for cheques drawn on banks in Shenzhen and Guangdong and presented in Hong Kong. Since March 2006, the joint cheque-clearing facilities have been expanded to cover renminbi cheques drawn on banks in Hong Kong, and presented in Shenzhen and Guangdong for consumer spending. In 2011 renminbi cheques with a total value equivalent to around $50 million were cleared.

Payment links with Macau

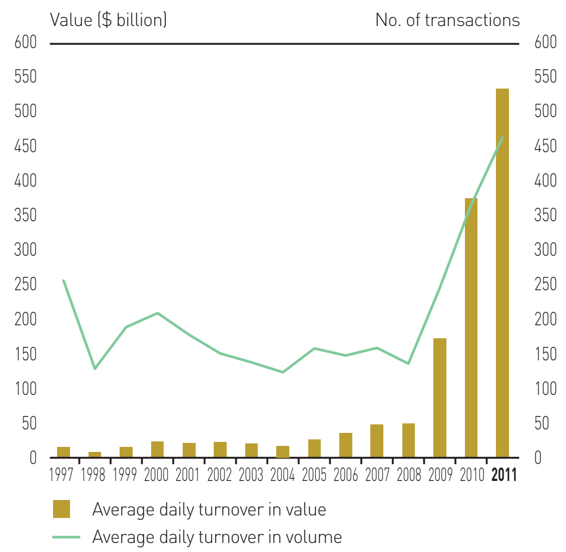
The one-way joint clearing facility for Hong Kong dollar cheques between Hong Kong and Macau was launched in August 2007 and a similar facility for US dollar cheques was launched in June 2008. The facilities have reduced the time required for clearing Hong Kong dollar and US dollar cheques issued by banks in Hong Kong and presented in Macau from four or five days to two days. In 2011 Hong Kong dollar cheques with a total value of about $24 billion and US dollar cheques with a total value of about US$10 million were cleared.

Debt settlement systems

The CMU provides an efficient, one-stop clearing, settlement and depository service for Hong Kong dollar and foreign currency-denominated debt securities issued in Hong Kong. Through the linkages between the CMU and international and regional CSDs, overseas investors can hold and settle securities lodged with the CMU. They also help Hong Kong investors hold and settle foreign securities held with overseas CSDs.

In 2011 the CMU processed an average daily value of $533 billion (462 transactions) in secondary market transactions (Chart 7). Among the debt securities lodged with the CMU at the end of the year, the outstanding amount of EFBN was $655 billion and the total amount of other securities was equivalent to $610 billion.

Chart 7 CMU secondary market turnover



Development of financial infrastructure

In 2011 the HKMA completed a number of projects to promote the safety and efficiency of the financial infrastructure, and capture new business opportunities to further develop Hong Kong as a regional payment and settlement hub.

Enhancement of the renminbi RTGS system

To assist Hong Kong to fully capture new business opportunities arising from the further expansion of renminbi market activities in Hong Kong, the HKMA, in collaboration with the Clearing Bank of the renminbi RTGS system, accelerated the process of enhancing the system, bringing the renminbi RTGS system largely in line with the Hong Kong dollar RTGS system in terms of functionality. On the back of the improved infrastructure, money settlement for the first renminbi initial public offering (IPO) (of a renminbi Real Estate Investment Trust) was efficiently handled through the system in April.

The enhancements made to the renminbi RTGS system in 2011 include:

- **broadening the scope of the types of renminbi paper clearing items in the daily bulk settlement runs** – apart from paper cheques, the renminbi paper clearing system was enhanced to accept other paper clearing items including cashier's order, gift cheque, dividend warrant, demand draft, remittance advice and traveller's cheque. The acceptance of renminbi cashier's order helps facilitate investors' applications for IPOs of renminbi-denominated stocks and other investment products

- **launching renminbi intra-day and overnight repo arrangements** – it helps strengthen banks' liquidity management ability, in particular during high liquidity-demand periods

- **launching same-day refund of Electronic IPO monies in renminbi** – similar to the Electronic IPO (EIPO) refund mechanism available in the Hong Kong dollar RTGS system, the enhancement shortens the settlement cycle of EIPO refund for renminbi-denominated IPOs by enabling EIPO subscribers to receive refunds on the refund day instead of on the next day

- **launching renminbi autopay system** – an electronic clearing system on a multilateral netting basis for autopay service was introduced to the renminbi RTGS system, providing an efficient and convenient platform for the auto-transfer of renminbi-denominated payments on behalf of customers at the cross-bank level within Hong Kong and across the border, such as utilities bill payments for auto-debit transactions and payroll and dividend payments for auto-credit transactions

- **launching renminbi CHATS Optimiser and renminbi Cross Currency CHATS Optimiser** – these liquidity saving devices play a significant role in ensuring the smooth recycling of liquidity during times of heavy fund flows, especially during IPO periods

- **launching renminbi-denominated electronic IPO and PPS financial service bulk money settlement runs in the morning and late afternoon** – these new bulk settlement runs can facilitate individual investors' electronic IPO subscriptions to renminbi-denominated stocks and electronic bill payments of renminbi-denominated financial services, such as insurance, through the PPS channel. In future, it can be further extended to cover other renminbi-denominated purchases made through the point-of-sale terminals of EPS Company (Hong Kong) Limited.

Hong Kong/Shenzhen cross-border one-way joint direct debit transfer

The third and last phase of establishing a cross-border one-way joint direct debit transfer arrangement between Hong Kong and Shenzhen was completed in March. The arrangement helps provide a more efficient means for Hong Kong residents to make recurring payments (such as property management fees and utilities bills) to Shenzhen merchants. The first and second phase of the project, launched in 2010, allow holders of Hong Kong dollar and renminbi China UnionPay (CUP) credit cards and Hong Kong dollar CUP debit cards issued in Hong Kong to make relevant cross-border payments. The third phase which resorts to the newly launched renminbi autopay system supports making payments through renminbi CUP debit cards issued in Hong Kong and through directly debiting renminbi bank accounts in Hong Kong.

CCASS T+2 money bulk settlement run

To align with international best practices, the project of advancing the money settlement for secondary market trading of listed securities from three days after trade day (T+3) to two days after trade day (T+2) was implemented in July under the close collaboration between the HKMA and Hong Kong Securities Clearing Company Limited. An additional bulk settlement run scheduled for late afternoon (for T+2 settlement), on top of the existing morning one (for T+3 settlement), was introduced to the Hong Kong dollar, US dollar and renminbi RTGS systems for money settlement of secondary market trading of listed securities. New Hong Kong dollar and renminbi CCASS Optimisers were also introduced at the same time to facilitate liquidity management of banks. In addition, the intraday repo windows of the relevant RTGS systems were extended from 6:00 p.m. to 6:30 p.m. to facilitate banks' liquidity management for the new T+2 CCASS bulk settlement runs.

Enhanced CMU bank-to-bank repo service

The bank-to-bank repo service of the CMU serves as a platform for CMU members to conduct sales and repurchases of securities pursuant to relevant master sale and repurchase agreements. To facilitate better risk management of bank repo transactions as a collateralised liquidity management tool and reduce reliance on uncollateralised lending, and to address lenders' concern about fluctuation in collateral prices, the enhanced CMU bank-to-bank repo service was launched in November, offering new features such as daily mark-to-market of outstanding repo transactions, user-defined eligible securities for repo transactions and automatic selection of eligible securities as collaterals.

Trade repository for OTC derivatives

The HKMA embarked on the development of a trade repository (TR) for OTC derivatives under the CMU in 2011. The TR of the HKMA will serve dual functions of capturing reports of OTC derivatives, initially interest rate swaps and non-deliverable foreign exchange forwards, submitted by the industry and supporting central clearing of eligible derivatives transactions at the central counterparty facility to be established by the Hong Kong Exchanges and Clearing Limited.

Due regard has been paid to evolving international TR reporting standards and local regulatory standards, and industry comments in setting and refining the design features of the TR system. The HKMA has participated in a number of international TR standard-setting bodies to keep abreast of relevant international developments. On-going dialogue has been maintained with the industry on the development and implementation of the TR system through a dedicated working group under the TMA. In July the HKMA issued a consultation paper on the logistical and technical arrangements for reporting to the TR of the HKMA, and published the report on the consultation in November. To allow sufficient time for the industry to get their systems ready, the HKMA finalised and published the technical specifications for TR reporting in December.

Retail payment initiatives

The HKMA worked with Octopus Card Limited (OCL) to facilitate cross-border development of e-money between Hong Kong and Guangdong Province during 2011. With the facilitation of the HKMA, OCL and GDPass Payment Network Company Limited signed a Heads of Agreement on the issuance of an Octopus and Lingnan Tong two-in-one card at the 14th Plenary of the Hong Kong/Guangdong Co-operation Joint Conference in August. Scheduled for launch in 2012, the Octopus and Lingnan Tong two-in-one card would cover public transport as well as certain retail purchases in Hong Kong, Guangzhou, Foshan, Jiangmen, Zhaoqing, Shanwei and Huizhou. The HKMA also facilitated similar discussions between OCL and Shenzhen Tong Company Limited with a view to expanding the coverage of the two-in-one card initiative.

In light of rapidly advancing technologies and growing demand for innovative retail payment services, the HKMA conducted a review of retail payment instruments and infrastructure in Hong Kong and overseas in 2011. The review concluded that it was in the interest of the banking industry, their customers and the general public in Hong Kong to move from paper-based payment solutions to higher adoption of electronic means and a number of initiatives were recommended to take the matter forward. The findings and recommendations of the review were generally supported by the banking industry. A working group comprising representatives of the HKMA and banking industry was formed in late 2011 to further study the initiatives and the approach to implementation.

In addition, the HKMA also conducted the preparatory work in late 2011 for a consultancy study on the strategic plan and the approach of developing an interoperable near field communication (NFC)[6] mobile payment infrastructure in Hong Kong. The study would benchmark Hong Kong with other developed markets and involve a number of stakeholders, including the banking sector, mobile network operators, payment service providers and mobile phone manufacturers. The results of the consultancy study would be used to facilitate the development of interoperable NFC mobile payment services in Hong Kong.

6 NFC technology enables consumers to install, among others, mobile payment applications such as e-purses onto their mobile phones and make contactless payments at retail outlets by tapping their mobile phones to the readers installed at retail outlets.

PLANS FOR 2012 AND BEYOND

The HKMA will work closely with other agencies and the private sector to consider and implement initiatives that will reinforce the competitiveness of Hong Kong's financial markets to strengthen its position as an international financial centre.

International and regional co-operation

The global economic outlook is expected to deteriorate in 2012 amid the slowdown in advanced economies and the on-going European sovereign debt crisis. Global financial markets are likely to remain turbulent along with heightened risk aversion. Volatile capital flows triggered by external or domestic events could pose considerable risks to the financial system of regional economies. This highlights the importance of enhancing co-operation for improving surveillance and contingency planning. The HKMA will continue to spearhead the macro-surveillance work for the EMEAP Monetary and Financial Stability Committee. Participation in central banking and international financial forums remains a priority of the HKMA to keep abreast of the latest developments. The HKMA will also continue to participate in international efforts in implementing the global financial regulatory reforms.

Hong Kong's sovereign credit ratings

With Standard & Poor's affirming Hong Kong's AAA credit rating, the HKMA will pursue further upgrades of ratings by other major international credit rating agencies.

Development of Hong Kong as the premier offshore renminbi business centre

Strengthening financial co-operation with the Mainland is important to enhancing Hong Kong's competitiveness as an international financial centre. The HKMA will liaise with Mainland authorities on issues related to the continued development of Hong Kong as a premier offshore renminbi business centre, and to expand CEPA to increase the financial integration between Hong Kong and the Mainland. To help promote the wider use of renminbi outside the Mainland and to extend the outreach of Hong Kong's offshore renminbi services to the international community, the HKMA is planning further roadshows to introduce the renminbi business platform provided by Hong Kong to overseas investors, companies and financial institutions in 2012.

In collaboration with the Clearing Bank of the renminbi RTGS system, preparations are being made to extend the operating hours of the renminbi RTGS system from the current 10 hours a day to 15 hours, under an operating window from 8:30 a.m. to 11:30 p.m., by June 2012. The extended operating window will be able to cover both the Asian and European business hours and the early US business hours, thus enabling participating banks to better serve their customers in different regions. The extension will bolster the competitiveness of the renminbi clearing platform in Hong Kong and continue to strengthen Hong Kong's status as the premier offshore renminbi business centre.

Market development

The HKMA will continue to participate in the Government's initiatives in further developing the local debt market and the Islamic finance sector, and in implementing the Government Bond Programme to broaden its investor base and establish a liquid and representative yield curve. It will also maintain a close, on-going dialogue with the private sector and industry associations to broaden the range and sophistication of market products and services.

With a view to further developing Hong Kong as an international asset management centre as set out in the 12th Five-Year Plan of the Central Government, the HKMA will continue its efforts to refine the financial platform of Hong Kong.

OTC derivatives market regulation

The HKMA will continue to work with the FSTB and the SFC towards finalising the regulatory regime for the OTC derivatives market in Hong Kong. A second joint consultation with the SFC will be conducted in 2012 to consult the public on the detailed requirements. The HKMA will maintain close contact with the industry to gather market views and design a regime that is in step with market practices. The HKMA will also continue to take part in various international forums, including the OTC Derivatives Working Group of the FSB and the OTC Derivatives Regulators' Forum to keep abreast of and contribute to regulatory developments in the international arena.

Financial infrastructure

Trade Repository for OTC derivatives

Subject to new developments on the international and local regulatory fronts that may warrant making a significant change to the design of the Trade Repository (TR) immediately, the TR system development work is expected to be completed in the first half of 2012. The TR system is expected to be ready for launch in the second half of 2012, subject to the progress on the development of the regulatory regime and the implementation of the central counterparty facility by the Hong Kong Exchanges and Clearing Limited. User registration and industry-wide system testing will be conducted well before mandatory reporting requirements start to take effect to ensure readiness of the industry. Meanwhile, the HKMA will start planning the second phase of system implementation, in anticipation of bringing on board new products and adding new functions in response to evolving international standards and requirements of local regulators.

Pan-Asian CSD Alliance project

Following the launch of the Pilot Platform for cross-border investment and settlement of debt securities on 30 March 2012, the HKMA will continue to work with central banks and Central Securities Depositories in the Asia Pacific region and Euroclear to introduce the add-on services such as cross-border collateral management and corporate action services to facilitate gradual migration to the Common Platform Model.

Retail payment initiatives

The HKMA will continue to facilitate discussions and implementation of the two-in-one card initiatives among the Octopus Card Limited, GDPass Payment Network Company and Shenzhen Tong Company Limited.
The HKMA will also work closely with the banking industry and other service providers to implement the recommendations arising from the retail payment review conducted in 2011, and further enhance the local electronic retail payment infrastructure taking into account findings of the consultancy study on NFC mobile payment services scheduled for completion within 2012. In light of increased innovation in and acceptance of the retail payment services, the HKMA will review the need for an enhanced regulatory framework of retail payment services to ensure the safety and soundness of retail payment instruments and services in Hong Kong.

Reserves Management

The Exchange Fund recorded an investment return of 1.1% in 2011, a year in which the macro-financial environment and investment markets were overshadowed by instability and uncertainty.

THE EXCHANGE FUND

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

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives and portfolio structure

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

(a) to preserve capital;

(b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid US dollar-denominated securities;

(c) to ensure that sufficient liquidity will be available for the purposes of maintaining monetary and financial stability; and

(d) subject to (a) – (c), to achieve an investment return that will help preserve the long-term purchasing power of the Fund.

These objectives take full account of the statutory purposes of the Exchange Fund, and are incorporated into the portfolio structure and the target asset allocation of the Fund.

The Exchange Fund is managed as two distinct portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio holds highly liquid US dollar-denominated assets to provide full backing to the Monetary Base as required under the Currency Board arrangements. The Investment Portfolio is invested primarily in the bond and equity markets of the member countries of the Organisation for Economic Co-operation and Development to preserve the value and long-term purchasing power of the assets. The long-term target bond-to-equity mix for the two portfolios as a whole is 75:25. In terms of target currency mix, 81% of the assets are allocated to the US dollar and the Hong Kong dollar and the remaining 19% to other currencies.

To better manage risks and enhance returns in the medium and long term, the HKMA has been diversifying part of the Fund's investment, in a prudent and incremental manner, into a greater variety of asset classes, including emerging market bonds and equities, private equity funds, overseas investment properties, and Mainland bonds and equities.

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

The investment process

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

Investment management

Direct Investment

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

Use of external managers

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

Expenditures relating to the use of external managers include fund management and custodian fees, transaction costs and withholding and other taxes. They are determined by market factors, and may fluctuate from year to year.

Risk management and compliance

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

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2011

Global financial markets remained highly volatile in 2011. Despite the earthquake in Japan and the social unrest in the Middle East and North Africa region, global equity markets generally rose in the first half of the year. But sentiment took a sharp downturn in the summer amid a US sovereign rating downgrade and escalating European sovereign debt crisis. As volatilities extended into the fourth quarter, major European stock markets finished the year significantly lower, while the US Standard & Poor's 500 Index barely reversed to the level recorded in the beginning of the year.

Investment work in the bond market was also challenging. Key government bond yields finished the year significantly lower despite a strong up-tick in the first quarter, as investors remained very concerned about the global economic outlook and the negative developments in the euro-zone sovereign debt market. The US Treasuries regained its status as the safest asset even after the sovereign rating was downgraded. Ten-year US Treasury bond yield ended at 1.88% in 2011, about 140 basis points lower than the level at the start of the year, and almost 190 basis points lower than the highest level seen in February.

On currency markets, the euro's strength in the first half of the year proved short-lived as the sovereign debt crisis worsened in the second half and the European Central Bank cut its policy rates in response. In 2011 the euro fell by 3.2%, while the yen gained more than 5% against the US dollar.

The performance of major currency, bond and equity markets in 2011 are shown in Table 1.

Table 1 **2011 market returns**

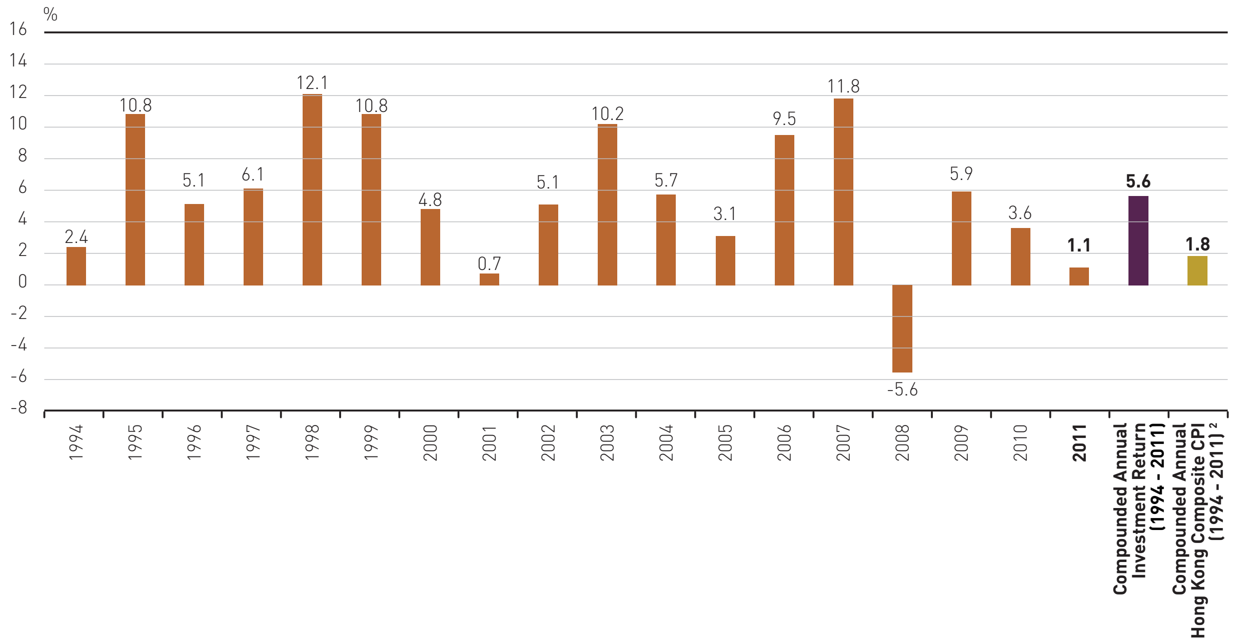
Currencies	
Appreciation (+)/depreciation (-) against the US dollar	
Euro	-3.2%
Yen	+5.4%
Bond markets	
Relevant US Government Bond (1 - 3 years) Index	+1.7%
Equity markets	
Standard & Poor's 500 Index	0.0%
Hang Seng Index	-20.0%

The Exchange Fund's performance

The Exchange Fund recorded an investment income of $27.1 billion in 2011, comprising a total return from bonds and a valuation gain on other investments held by the investment holding subsidiaries of the Fund of $71.9 billion and $0.7 billion respectively, losses from Hong Kong and foreign equities of $24.2 billion and $12.2 billion respectively, and a loss of $9.1 billion from foreign exchange revaluation. Apart from this $27.1 billion investment income, the valuation loss, net of dividend income, of the Strategic Portfolio amounted to $2.9 billion. The investment return of the Exchange Fund after excluding the Strategic Portfolio is 1.1%. The annual return of the Fund from 1994 to 2011 is set out in Chart 1. Table 2 shows the 2011 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 3.5% over the last three years, 3.2% over the last five years, 4.9% over the last 10 years and 5.6% since 1994.[1] Table 3 shows the currency mix of the Fund's assets on 31 December 2011.

[1] Averages over different time horizons are calculated on an annually compounded basis.

Chart 1 Investment return of the Exchange Fund (1994 – 2011)[1]



[1] Investment return calculation excludes the holdings in the Strategic Portfolio.
[2] Composite Consumer Price Index is calculated based on the 2009/2010-based series.

Table 2 Investment return of the Exchange Fund in Hong Kong dollar terms[1]

	Investment return[2 & 3]
2011	1.1%
3-year average (2009 – 2011)	3.5%
5-year average (2007 – 2011)	3.2%
10-year average (2002 – 2011)	4.9%
Average since 1994	5.6%

[1] The investment returns for 2001 to 2003 are in US dollar terms.
[2] Investment return calculation excludes the holdings in the Strategic Portfolio.
[3] Averages over different time horizons are calculated on an annually compounded basis.

Table 3 Currency mix of the Exchange Fund's assets on 31 December 2011 (including forward transactions)

	HK$ billion	**%**
US dollar	1,945.6	78.2
Hong Kong dollar	186.4	7.5
Others[1]	356.0	14.3
Total	**2,488.0**	**100.0**

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

Corporate Functions

The HKMA continues to maintain effective communication with the community at large through the media, regular briefings at the Legislative Council, public education programmes and other channels. Resources are deployed strategically in the pursuit of our corporate mission to maintain monetary and banking stability.

CORPORATE DEVELOPMENT

Media relations

The HKMA attaches great importance to maintaining effective and timely communications with the media to provide transparency and accessibility to its operations. Initiatives were taken in 2011 to strengthen this relationship and improve the understanding of the HKMA's policies and work by the media and the public. During the year, 76 open press events comprising 17 press conferences, 15 stand-up interviews and 44 other public functions were held. Another 76 media interviews were given. Altogether 327 bilingual press releases were issued and staff handled a large volume of media enquiries each day.

In addition, 15 media briefings were organised covering a wide range of topics to facilitate better understanding of the HKMA's operations and initiatives. These included investment performance of the Exchange Fund, banking policies and regulations, prudential measures for mortgage lending, implementation of Positive Mortgage Data Sharing and offshore renminbi business development.

Chief Executive of the HKMA, Mr Norman Chan, briefs the media on a range of topical issues.

Public enquiries

The Public Enquiry Service received 10,555 enquiries in 2011, reflecting the continued public interest in the work of the HKMA.

About half the enquiries were on consumer banking issues, and banking policies and regulations. Notable examples of enquiries included prudential measures on residential mortgage loans and the implementation of Positive Mortgage Data Sharing. A large number of enquiries about the inflation-linked bonds (iBonds) and the 2010 new series banknotes were also received. Chart 1 shows the number of enquiries received since 2008, while Chart 2 breaks down the enquiries in 2011 by type.

Chart 1 **Total number of public enquiries**

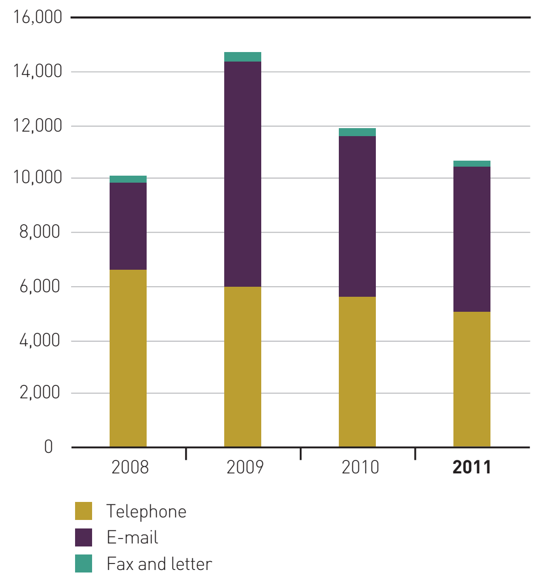
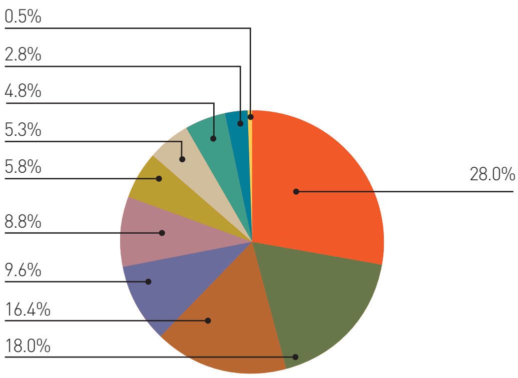


Chart 2 Nature of enquiries received in 2011



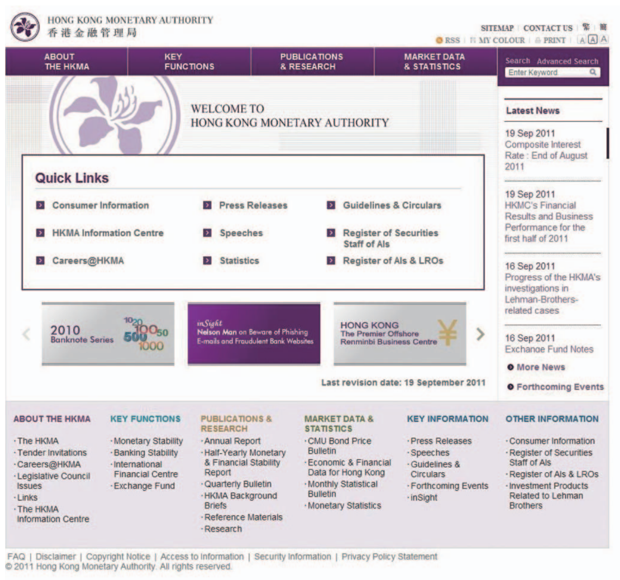
Publications

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

The *HKMA Annual Report 2010* received a Silver award in the Hong Kong Management Association's 2011 Best Annual Reports Awards.

The HKMA website

The HKMA launched its redesigned website (www.hkma.gov.hk) in September 2011 to make browsing and information search easier. New features include online "Register of Authorized Institutions and Local Representative Offices" and the "Really Simple Syndication" function to facilitate the tracking of updates.



The redesigned HKMA website launched in September 2011.

Public education programme

The Information Centre on the 55th Floor of Two International Finance Centre is an important resource for introducing the HKMA's work to the community and promoting public awareness of monetary and banking matters.

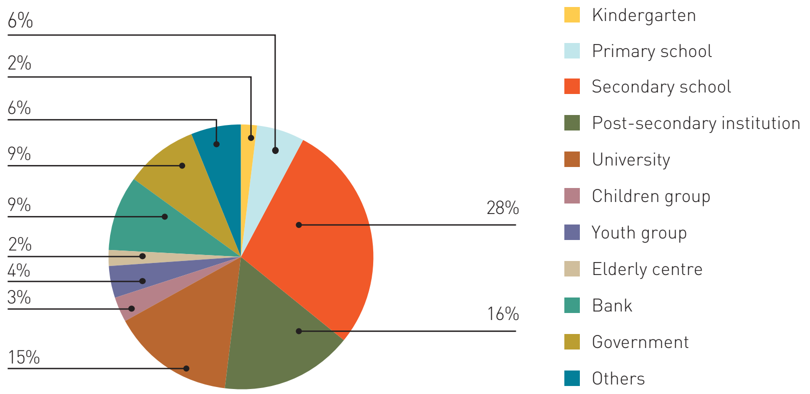
The Centre consists of an exhibition area and library, and is open to the public six days a week. Displays cover the history of money and banking in Hong Kong, the key policy objectives of the HKMA, and provide information on Hong Kong's banknotes, Internet banking security, the payment systems and deposit protection. Daily guided tours are organised for visitors. During the year, the Centre received more than 38,000 visitors and hosted over 500 guided tours for schools and other groups (Chart 3). Over 373,000 visitors have visited the Centre since it opened in December 2003.

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

The HKMA continued to organise public education seminars on topics relevant to its work. In 2011, three seminars were held for over 2,000 students, teachers and members of the public. The Linked Exchange Rate system, Hong Kong's banknotes and the work of the HKMA were the main topics. Since the launch of the education programme in 1998, more than 46,000 people have participated in the seminars.

The Vice-Premier of the State Council, Mr Li Keqiang, is briefed by the Chief Executive of the HKMA, Mr Norman Chan, during his visit to the HKMA Information Centre on 17 August. The Chief Executive of the HKSAR, Mr Donald Tsang, and the Governor of the People's Bank of China, Mr Zhou Xiaochuan, accompanies Mr Li.

Chart 3 **Type of group visits to the Information Centre**



Corporate Functions

HUMAN RESOURCES

The HKMA needs to recruit, develop and maintain a highly professional workforce to support its policy objectives and respond flexibly to changing work priorities. While the HKMA is an integral part of the Government, it is able to employ staff on terms different to those of the civil service to attract personnel of the right experience and expertise. As a public organisation, the HKMA aims to maintain a lean and flexible structure and to redeploy staff resources to meet new and increased workload whenever possible.

Organisational changes

In December 2011 the Financial Stability Surveillance Division was formed under the Monetary Management Department to strengthen macro-financial surveillance. The Division comprises staff from the Banking Policy Department and the Monetary Management Department previously engaged in market surveillance work. The Treasury and Derivatives Teams in the Banking Policy Department were transferred to the Banking Supervision Department and the duties of some Divisions in the Banking Supervision Department were reshuffled to streamline operations. The Support Services Division of the Monetary Management Department was renamed Currency Division to reflect more clearly its function.

In January 2012 the duties of two Deputy Chief Executives were reshuffled. Mr Peter Pang took over Mr Eddie Yue's responsibilities for the Monetary Management Department and the Financial Infrastructure Department, while continuing to oversee the Research Department and The Hong Kong Mortgage Corporation Limited. Mr Yue took over Mr Pang's responsibilities for the External Department and the Corporate Services Department, and continued to oversee the Reserves Management Department.

Staffing

The staffing establishment of the HKMA at the beginning of 2011 was 775. Twelve temporary positions in the Enforcement Department were converted into permanent posts in October in order to strengthen the core team of experienced permanent staff to supervise and guide the operations of the enforcement and banking complaint handling functions. At the end of 2011, the establishment was 787.

In January 2012, seven new posts were added to enhance support for essential activities, bringing the total establishment to 794 (an increase of 0.9%) (Table 1). These new posts will be deployed in the following areas:

- strengthening surveillance of global economic and financial developments
- promoting Hong Kong as a premier financial services hub
- strengthening supervision on customer and investor protection
- enhancing internal support, control and risk management.

Table 1	Establishment and strength of the HKMA on 1 January 2012

Department	Functions	Senior staff Establishment	Senior staff Strength	Others Establishment	Others Strength
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	7	7
Banking Conduct	To focus on payment systems oversight, licensing, deposit protection and settlement, and all supervisory and development functions relating to the business conduct of authorized institutions.	1	1	99	93
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	29	29
Banking Supervision	To supervise day-to-day operations of authorized institutions.	1	1	160	157
Enforcement	To focus on securities enforcement and complaint handling functions.	1	1	61	56
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through participation in the international central banking and financial community.	1	1	51	49
Financial Infrastructure	To develop and enhance the financial market infrastructure important for maintaining and strengthening Hong Kong as an international financial centre.	1	1	25	25
Monetary Management	To maintain financial and monetary stability through macro-financial surveillance, monitoring of market operations and development issues, and to ensure adequate supply of banknotes and coins.	1	1	39	39
Research	To conduct research and analysis on economic and international financial market developments in Hong Kong and other economies.	1	1	37	36
Reserves Management	To manage reserves to achieve investment returns in line with established guidelines and to enhance the quality of return by diversifying into different investment markets and asset types.	1	1	82	79
Office of the General Counsel	To provide in-house legal support and advice.	1	1	20	19
Corporate Services	To provide support services in the form of administrative, finance, human resources, information technology and secretariat services, and to handle media and community relations.	1	1	159	154
Internal Audit	To provide audit services through assisting management in controlling risks, monitoring compliance and improving the efficiency of internal control systems and procedures.	–	–	10	8
Total		**15**	**15**	**779**	**751**

Temporary resources will continue to be deployed to meet other work demands. The number of temporary staff hired for handling banking complaints had been reduced from the peak of about 200 in 2009 to around 40 in January 2012.

The HKMA transfers staff on secondment to other international or local organisations such as the International Monetary Fund and the Hong Kong Interbank Clearing Limited to help co-ordinate activities or policy initiatives in which Hong Kong or the HKMA has an interest. Some staff are deployed on a full-time or part-time basis to provide operational support to the Hong Kong Deposit Protection Board and the Treasury Markets Association.

Remuneration policies and pay review mechanism

The Financial Secretary (FS) determines the pay and conditions of service for HKMA staff on the advice of the Exchange Fund Advisory Committee (EFAC) and its Governance Sub-Committee (GSC) taking into account the prevailing market rates and practices. Remuneration comprises a total cash package and a Provident Fund Scheme, with minimal benefits in kind. The cash package consists of fixed pay, which is payable monthly, and variable pay, which may be awarded to individual staff members as a lump sum once a year depending on performance.

Pay for HKMA staff is reviewed annually by the FS in the light of recommendations made to him by the GSC through EFAC, taking into account the findings of independent consultants on pay trends and pay levels in the financial sector, the GSC's assessment of the performance of the HKMA during the preceding year, and other appropriate factors.

Any approved annual adjustments to the fixed pay or any variable pay awards for the HKMA are distributed to individual staff based on their performance. Taking into account advice from independent consultant, the variable pay system for investment professionals in the HKMA was modified in 2011 to strengthen the linkage between their investment performance and remuneration award. The pay adjustments or awards to individual staff members at the ranks of Executive Director or above are approved by the FS on the advice of the GSC. The staff members concerned are not present at the meetings when their pay is discussed. The pay adjustments or awards for individual staff at the ranks of Division Head and below are determined by the Chief Executive of the HKMA under delegated authority from the FS and within the approved overall pay awards.

Remuneration of senior staff

The remuneration packages of the senior staff in 2011 are shown in Table 2.

Table 2 **Remuneration packages of HKMA senior staff in 2011**[1]

$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff[2]	1	3	12
Annualised pay			
Fixed pay	6,000	5,180	3,283
Variable pay	2,038	1,519	704
Other benefits[3]	1,000	468	377

Notes:

1 Except for annual leave accrued, the actual remuneration received by staff during 2011 but not serving a full year is annualised for the purpose of calculating the average annual package for the rank.

2 The number of staff in this table at the Executive Director rank includes the Chief Executive Officer of the Hong Kong Mortgage Corporation.

3 Other benefits include provident funds, medical and life insurance and annual leave accrued during the year. The provision of these benefits varies among senior staff depending on individual terms of service.

Training and development

The HKMA places great emphasis on developing staff capabilities to meet operational needs, career development and new challenges. During the year, HKMA staff were provided with 3,228 training days compared with 2,799 in 2010. These included 1,343 days of horizontal training in general skills, and 1,885 days of vertical training in job-specific topics. Each staff received on average 4.39 days of training.

As part of the horizontal training programme, courses on central banking and the core functions of the HKMA were organised for new staff. Several team-building workshops were conducted to enhance the spirit of teamwork at the workplace. Courses on English writing skills were conducted during the year focusing mainly on support staff, while workshops on appraisal skills, objective-setting, public speaking and presentation skills, were attended by managerial staff. Putonghua courses and training on PC skills were provided to staff at various ranks. There were workshops targeted at staff of individual sections, such as media training for the Communications Unit. Training for senior staff included executive leadership programmes run by local universities and organisations, national studies courses organised by the Chinese Academy of Governance in Beijing, and central banking courses organised by the Federal Reserve Bank of New York.

During the year, a comprehensive in-house training programme was organised for newly-recruited Assistant Managers in the Banking Departments. The course lasted for two weeks and aimed to provide participants with the necessary knowledge and skills to perform the duties of an Assistant Manager in the Banking Departments. It covered basic banking supervisory topics including supervisory approach, core principles for effective banking supervision, Banking Ordinance and regulatory framework, CAMEL rating, capital adequacy, statutory returns, Basel II and III, major banking risks, on-site examination and off-site review. In-house training on specific topics was also organised for Banking staff throughout the year to update them on the latest developments, including updates on renminbi business, implementation of positive mortgage data sharing, sound systems and controls for liquidity-risk management, benchmarking of stress-testing practices, Basel III and mystery-shopping programme. Training courses offered by multilateral organisations and other central banks that were not available in Hong Kong were also identified for colleagues.

The HKMA runs a Training Sponsorship Scheme to help staff pursue further studies relevant to the work of the HKMA with a view to enhancing their knowledge-base and professional standards. Partial reimbursement of membership dues of relevant professional bodies is also provided.

Besides formal training, staff briefings were conducted by the senior executives and external speakers on a range of topics related to the work of the HKMA.

Corporate Functions

GENERAL ADMINISTRATION

The HKMA continued to streamline its work to improve efficiency and cost-effectiveness to cope with the increasing workload. Business continuity plans are kept under constant review to ensure their effectiveness in a changing business environment. An evacuation drill and a drill of activation of the back-up office are held every year. The Event Management Team monitors the response level of influenza pandemic in Hong Kong and implements necessary precautionary and contingency measures as appropriate.

The HKMA takes various steps to protect and preserve the environment. All HKMA staff support recycling campaigns in collecting clothes, toys, computers and other reusable items for donation to charities. Waste paper and used printer cartridges are also collected for recycling. The HKMA supports the use of recycled paper, which constitutes over half of the total paper consumption. Following a 14% reduction of paper consumption in 2010, the HKMA has reduced paper consumption by another 12.6% in 2011, along with other green achievements in reducing envelope consumption (67.9%) and electricity consumption (2.8%).

During 2011 HKMA staff teams participated in and raised funds for a number of charity events. The HKMA Team was the first runner-up of the Corporate Cup of the Sowers Action Charity Marathon and the UNICEF Half Marathon, and the second runner-up in the Bank Category of the Green Power Hike. HKMA staff took part in Blood Donation Day, the Community Chest's Dress Special Day and Love Teeth Day. In 2011 the HKMA Volunteer Team gave more than 170 hours of their free time to serving the community, including assisting in the donation exercise on recycled computer and peripherals to Caritas Computer Workshop, and participating in various volunteer services organised by the Agency for Volunteer Service.

The HKMA procures office supplies from a workshop operated by people with disabilities. In recognition of its commitment to corporate citizenship, the Hong Kong Council of Social Service awarded the "5 Years Plus Caring Organisation Logo" to the HKMA.

FINANCE

Annual budget

In drawing up the annual budget, the HKMA takes into account both its continuing operations and its strategic development set out in a three-year plan approved by the FS on the advice of EFAC. Departments are required to assess their needs for the coming year and to consider where savings in staffing and expenditure can be achieved. This requires departments to critically assess the value of existing services and the cost-effectiveness of delivery methods. The Finance Division scrutinises all budget requests and discusses them with individual departments before submitting a consolidated draft budget for scrutiny by senior management. The GSC of EFAC then deliberates on the budget and recommends any changes it believes are necessary, before putting it through EFAC to the FS for approval.

All expenditure is subject to stringent financial controls through procurement rules and guidelines. Compliance with these guidelines is subject to internal audit and is reviewed by independent auditors during the annual audit of the Exchange Fund. Expenses are analysed and reported to senior management every month.

The administrative expenditure in 2011 and the budgeted expenditure for core activities in 2012 are shown in Table 3. With the establishment of the Enforcement Department and the substantial completion of the investigation work for Lehman-related complaints, the project funding for investigation of complaints about banking services ceased at the end of 2011 and on-going expenses for handling complaints are provided for in the administrative expenditure starting from 2012. Having regard to this change, figures in Table 3 have included the relevant expenditure. The difference between the 2011 actual expenditure and the 2012 budget arises mainly from an increase in staff costs, reflecting the full-year effect of staff increases in 2011 for enhancing the work on enforcement and banking complaint handling, and the increase of seven posts to strengthen support for essential activities in different areas of the HKMA's work, approved for 2012 by the FS on the advice of EFAC.

Expenses related to premises for international organisations, whose presence in Hong Kong reflects its status as an international financial centre, are expected to remain stable in 2012. Expenditure continued in 2011 on the programme to upgrade Hong Kong's financial infrastructure, including further strengthening Hong Kong's position as a regional payment hub, undertaking preparatory work for the establishment of a trade repository, and keeping infrastructure at the forefront of technology and in compliance with new standards.

Spending on financial infrastructure is not related to the HKMA's own operations, but to providing and expanding payment and other systems to enable markets to function efficiently. These expenses are shown in Table 4. The HKMA also provides operational support to the Hong Kong Deposit Protection Board on a cost-recovery basis as endorsed by the FS according to section 6 of the Deposit Protection Scheme Ordinance (Cap. 581).

Table 3 HKMA administrative expenditure

$ million	2011 Budget*	2011 Actual	2012 Budget*
Staff costs	886		935
Salaries and other staff costs		751	
Retirement benefit costs		59	
Premises expenses			
Operating lease charges	16	15	17
Other premises expenses (including utility charges and management fees)	42	42	48
General operating costs			
Maintenance of office and computer equipment	55	52	60
Financial information and communication services (including trading, dealing terminals and data link charges)	45	40	54
External relations (including international meetings)	46	29	54
Professional and other services	54	28	49
Training	9	7	9
Others	13	10	23
Total administrative expenditure	**1,166**	**1,033**	**1,249**

* Includes supplementary budget and relevant provisions in project budgets and expenses related to handling of complaints about banking services.

Table 4 Additional expenses

$ million	2011 Budget*	2011 Actual	2012 Budget*
Subsidy to the Hong Kong Institute for Monetary Research	20	15	21
Premises expenses of international financial organisations in Hong Kong	31	30	32
Service fees for financial infrastructure	72	51	97

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

In addition to investment income from managing the Exchange Fund, the HKMA earns revenue through licence fees paid by AIs, and custodian and transaction fees from users of the Central Moneymarkets Unit. In 2012 licence fees are estimated at $137 million (2011: $136 million), cost recovered from the Hong Kong Deposit Protection Board and the other income components (excluding investment income) at $74 million (2011: $79 million).

Financial disclosure

The HKMA adopts best practices in financial disclosure as far as these are consistent with central banking operations. These standards include the reporting requirements laid down by the Special Data Dissemination Standard of the International Monetary Fund. In the absence of specific reporting requirements applying to central banking institutions, the HKMA adopts the disclosure requirements applicable to commercial entities as far as possible to achieve a high level of transparency. Working with the external auditor and other accounting professionals, the Finance Division prepares and presents the group financial statements in accordance with the Hong Kong Financial Reporting Standards applicable to central banking operations. The *HKMA Annual Report* compares favourably with those of other central banking institutions and monetary authorities: it contains detailed disclosure and thorough analyses of a wide range of expense items and budgetary information.

INFORMATION TECHNOLOGY

The Information Technology Division maintained 100% operational uptime in 2011 for all time-critical systems. In April 2011 an organisation-wide Business Continuity Management (BCM) exercise was carried out with the participation of all senior management staff. The recovery time of all information technology (IT) systems met the required targets and all business functions operated satisfactorily in the BCM mode.

To ensure continued reliability of the HKMA's IT system, ageing components of the IT infrastructure including firewall systems and financial services like SWIFT system were updated in 2011. Taking into account evolving mobile technology, the Division also provided enhanced communication support to staff on the move. In order to further enhance IT security in the HKMA, the Division was implementing new security information and event management technology which can improve the current log review process and enable early security warning. This will make the IT environment more resilient against emerging security threats.

To meet the Banking Departments' evolving needs for IT support in discharging their responsibilities, a revamp of the existing banking supervisory information system was initiated in 2011. The new system will provide users with more business intelligence software tools so as to enable better utilisation of the data stored in the system in an effective and timely manner.

The Division continued to support the Hong Kong Deposit Protection Board in improving its payout efficiency by implementing the payout system enhancements identified in simulations and rehearsals.

SETTLEMENT SERVICES

The Settlement Section provides settlement and operational support to ensure efficient and reliable transfers of funds or assets of the Exchange Fund arising from reserves management, monetary operations and other activities of the HKMA. With potential settlement and operational risks and the range of trading products and markets increasing, the Settlement Section remains vigilant towards issues that may arise during provision of settlement services. To ensure robust settlement operations, the Settlement Section dedicated a team to support the development of a new in-house investment and settlement processing system in 2011. A Pricing Unit was also established to ensure the integrity of pricing used in investment revaluation.

The Settlement Section and the Pricing Unit are committed to effective risk control mechanisms for settlement and operational support, and ensuring the segregation of duties and avoiding conflicts of interest between the monetary operations and reserves management functions of the HKMA. They are grouped under the Banking Conduct Department, which is separated from other functions of the HKMA.

OFFICE OF THE GENERAL COUNSEL

The Office of the General Counsel (OGC) is responsible for providing legal advice to the HKMA on all aspects of its functions and activities. It comprises 13 lawyers who assist the HKMA in maintaining Hong Kong's banking and monetary stability, enhancing its financial infrastructure, maintaining its status as an international financial centre, and ensuring the effective management of the Exchange Fund.

In addition to providing legal support to the operation of each line department within the HKMA, the OGC assists in the planning and implementation of projects, initiatives and operations, most of which involve complex issues of commercial, regulatory and administrative law. Examples include:

- preparation of legislative amendments to the Banking Ordinance for implementation of the Basel III framework

- formulation of the proposed regulatory regime for the over-the-counter (OTC) derivatives market, including establishing a trade repository in Hong Kong for OTC derivatives transactions

- formulation of proposals for regulating insurance intermediation services by authorized institutions as part of the new regulatory regime for insurance industry

- preparation of legislative amendments to the Mandatory Provident Fund Schemes Ordinance to establish a statutory regulatory regime for mandatory provident fund intermediaries

- continued development of the bond markets in Hong Kong and Asia, including the launch of iBond, and negotiations for the HKMA's status and participation as a Qualified Foreign Institutional Investor in the China interbank bond and securities markets

- continued development of the renminbi business in Hong Kong, including negotiating the Renminbi/Hong Kong Dollar Swap Agreement with the People's Bank of China, and launching the renminbi fiduciary account service to facilitate participating banks to better manage their credit exposure to the Clearing Bank for renminbi business in Hong Kong

- deliberation on effective resolution regimes to strengthen cross-border resolution for global systemically important financial institutions, including active participation in the Financial Stability Board (FSB) Steering Group for resolution regimes and preparation of bank-specific cross-border co-operation agreements

- deliberation on arrangements to improve information gaps and systemic linkages for global systemically important banks, including active participation in the FSB Data Gaps Implementation Group.

The OGC manages HKMA litigation matters and provides comments to government bureaux on significant legislative proposals from time to time, such as the Companies Bill. OGC lawyers participate in regular meetings and conferences for central bankers, financial regulators and the banking community to keep abreast of topical developments in major international financial centres; and to discuss and resolve issues of current legal concern. The OGC assists in promoting education and awareness of the HKMA's work and legal issues by taking up speaking engagements in academic programmes, professional symposiums and international forums.

Corporate Functions

INTERNAL AUDIT

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

During the year the Internal Audit Division co-ordinated the annual organisation-wide risk assessment exercise and reported the results to the Risk Committee and the Audit Sub-Committee. Using a risk-based approach, operational audits and system security reviews were conducted to cover all the significant risks facing the HKMA. The Division also reviewed the corporate governance and operations of the Hong Kong Deposit Protection Board. With effect from 2011, the HKMA's banking supervisory function was included in the Division's audit work plan. The Division advised on major system development projects and responded to management requests on internal-control matters, as well as advising senior executives on issues with control implications.

To keep abreast of development in practices in the internal audit profession and other central banks, the Division attended the meeting of Heads of Internal Audit for Asia-Pacific central banks and monetary authorities organised by the Bank for International Settlements to exchange views and share experiences in risk management and audit matters. It also participated in the seminar on recent regulatory reforms organised by Financial Stability Institute in Basel and attended the International Conference of the Institute of Internal Auditors held in Kuala Lumpur. In addition, professional staff attend seminars and training courses on the latest risk-management practices and audit techniques.

RISK MANAGEMENT

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

In 2011 the HKMA has strengthened its risk management framework with the establishment of the Macro Surveillance Committee (see the "Macro-prudential Surveillance" paragraph in the Chapter on Monetary Stability for details) and refinements of the roles and responsibilities of the Risk Committee. Both Committees are chaired by the Chief Executive.

The terms of reference of the Risk Committee are:

- to identify potential risks and threats to the organisation and devise strategies to reduce the impact of such events
- to review the existing system for managing risks across different departments to identify possible gaps and significant risks and ensure the adequacy of measures to address them
- to harmonise the criteria and methods of risk measurement and prioritise the resources management of risks identified
- to encourage a stronger risk management culture institutionally that promotes the proper levels of authorisation and controls.

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

EXTERNAL AUDITOR

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

The Exchange Fund

Report of the Director of Audit

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.

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

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

2 April 2012

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2011

(Expressed in millions of Hong Kong dollars)	Note	Group 2011	Group 2010	Fund 2011	Fund 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 2011	Group 2010	Fund 2011	Fund 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 2011	Group 2010	Fund 2011	Fund 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					
			Other reserves				
		Accumulated surplus	Revaluation reserve	Translation reserve	Total attributable to owner of the Fund	Non-controlling interests	Total
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 2011	Group 2010	Fund 2011	Fund 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 2011	Group 2010	Fund 2011	Fund 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.

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.

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.

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).

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.

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).

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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).

(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.

(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

(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.

(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:

	Group	
HK$	**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.

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

5 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

			Group – 2011					
	Note	Total	Trading financial instruments and hedging instruments	Financial assets and financial liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	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

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

	Group – 2010							
	Note	Total	Trading financial instruments and hedging instruments	Financial assets and financial liabilities designated at fair value	Loans and receivables	Held-to-maturity securities	Available-for-sale securities	Other financial liabilities
Cash and money at call	6	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

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

	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
		Fund – 2011						
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

(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

(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.

(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.

(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									
	2011					2010				
	Total	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Total	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

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

	Fund									
	Notional amounts with remaining life of									
	2011					2010				
	Total	3 months or less	1 year or less but over 3 months	5 years or less but over 1 year	Over 5 years	Total	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

(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	**–**	–

(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

(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.

(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

(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.

(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).

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

18 PROPERTY, PLANT AND EQUIPMENT

(a)

	Group			
	Premises	Plant and equipment	Computer software licences and system development costs	Total
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

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

	Fund			
	Premises	Plant and equipment	Computer software licences and system development costs	Total
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

(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.

(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%).

(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

(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.

(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	**–**	–

(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

(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

(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

		Group		Fund	
	Note	**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

(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

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

	Group									
	Currency Board Operations (note 31(a))		Reserves Management		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

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

	Group									
	Currency Board Operations (note 31(a))		Reserves Management		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).

(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.

		Group		Fund	
	Note	**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.

(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).

(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).

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.

(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.

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.

(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.

(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:

		Group		Fund	
	Note	**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.

(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 rating[1]				
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 rating[1]				
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.

(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	**–**	–

(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.

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.

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.

(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 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	Non-interest-bearing financial instruments
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).

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

	Group – 2010 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	Non-interest-bearing financial instruments
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).

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

	Fund – 2011 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	Non-interest-bearing financial instruments
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).

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

	Fund – 2010 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	Non-interest-bearing financial instruments
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).

(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.

(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.

(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 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	Total
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

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

	Group – 2010 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	Total
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

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

	Fund – 2011 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	Total
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

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

	Fund – 2010 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	Total
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.

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.

(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:

		Group			
		Carrying value		Fair value	
	Note	**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.

(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			
	Level 1	**Level 2**	**Level 3**	**Total**
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			
	Level 1	Level 2	Level 3	Total
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.

(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).

(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	1 July 2011
– Disclosures – Offsetting Financial Assets and Financial Liabilities	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.

Calendar of Events 2011

1 January
The enhanced Deposit Protection Scheme providing a higher protection limit of $500,000 comes into operation.

13 January
The People's Bank of China (PBoC) announces a pilot scheme for the settlement of overseas direct investments in renminbi.

1 March
The Securities and Futures Commission (SFC) and the HKMA reach a settlement agreement with a bank in relation to its distribution of equity-linked notes issued and guaranteed by Lehman Brothers.

14 March
The HKMA issues a circular to strengthen the regulation of the sale of investment-linked assurance scheme products by authorized institutions (AIs).

17 March
The HKMA holds the first of a series of overseas roadshows in Australia showcasing Hong Kong as the offshore renminbi business centre.

31 March
The Renminbi Clearing Bank announces that AIs participating in renminbi business can place renminbi funds in excess of their day-to-day business and settlement needs in a segregated Fiduciary Account with the PBoC through the Renminbi Clearing Bank.

1 April
The amended Code of Practice on Consumer Credit Data takes effect, allowing positive mortgage data sharing among credit providers.

11 April
The HKMA issues a circular requiring AIs to submit their re-assessed loan business plans and funding strategies for the remainder of the year to the HKMA for review.

18 April
The HKMA introduces a new investor protection measure, requiring AIs to provide Important Facts Statements for currency-linked instruments and interest rate-linked instruments to retail customers to enhance product disclosure.

1 June
The HKMA issues a circular requiring AIs to implement chip-based technology on all Automatic Teller Machine services in Hong Kong to enhance service security.

10 June
The HKMA introduces further prudential measures on property mortgage loans.

15 June
The HKMA holds its second overseas roadshow of the year in Russia showcasing Hong Kong as the offshore renminbi centre.

8 July

The SFC and the HKMA reach a settlement agreement with a bank over its distribution of market-linked notes and equity-linked notes issued by Lehman Brothers between March 2007 and June 2008.

22 July

The HKMA and the three note-issuing banks unveil the designs of the $100, $50 and $20 of the 2010 series Hong Kong banknotes.

28 July

A total of $10 billion inflation-linked retail bond under the Government Bond Programme is issued and subsequently listed on the Stock Exchange of Hong Kong on 29 July.

17 August

Vice-Premier of the State Council Mr Li Keqiang announces during his visit to Hong Kong a series of measures to support the development of Hong Kong as the offshore renminbi business centre.

13 September

The HKMA holds its third overseas roadshow of the year in the United Kingdom showcasing Hong Kong as the offshore renminbi centre.

14 October

The PBoC and the Ministry of Commerce promulgate the Administrative Rules on Settlement Business of Foreign Direct Investment Denominated in Renminbi.

17 October

The HKMA and the SFC issue a joint consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong.

The HKMA holds its fourth overseas roadshow of the year in Spain showcasing Hong Kong as the offshore renminbi centre.

22 November

The PBoC and the HKMA sign a renewed currency swap agreement for a term of another three years with the size expanded from RMB200 billion to RMB400 billion.

25 November

The HKMA releases the findings of its on-site examinations of Initial Public Offering sponsorship activities.

9 December

The Banking (Amendment) Bill is gazetted, paving the way for implementation of Basel III.

The International Monetary Fund releases its Staff Report on Hong Kong, setting out its strong endorsement of the Linked Exchange Rate system and commending the Government's effort in safeguarding financial stability.

13 December

The Eighth Supplement to the Closer Economic Partnership Arrangement is signed, allowing any Mainland-incorporated subsidiary of Hong Kong banks to engage in the sale and distribution of mutual funds; and supporting Mainland banks' use of Hong Kong's international financial platform to develop international businesses.

Annex and Tables

Annex Authorized Institutions and Local Representative Offices at 31 December 2011

LICENSED BANKS

Incorporated in Hong Kong

Bank of China (Hong Kong) Limited
Bank of East Asia, Limited (The)
China Construction Bank (Asia) Corporation Limited
Chiyu Banking Corporation Limited
Chong Hing Bank Limited
CITIBANK (HONG KONG) LIMITED
CITIC Bank International Limited
Dah Sing Bank Limited
DBS BANK (HONG KONG) LIMITED
FUBON BANK (HONG KONG) LIMITED
Hang Seng Bank, Limited
Hongkong & Shanghai Banking Corporation Limited (The)
Industrial and Commercial Bank of China (Asia) Limited
MEVAS Bank Limited
Nanyang Commercial Bank, Limited
PUBLIC BANK (HONG KONG) LIMITED
Shanghai Commercial Bank Limited
Standard Bank Asia Limited
Standard Chartered Bank (Hong Kong) Limited
Tai Sang Bank Limited
Tai Yau Bank, Limited
WING HANG BANK, LIMITED
Wing Lung Bank Limited

Incorporated outside Hong Kong

ABN AMRO Bank N.V.
AGRICULTURAL BANK OF CHINA LIMITED
Allahabad Bank
Australia and New Zealand Banking Group Limited
Axis Bank Limited
Banca Monte dei Paschi di Siena S.p.A.
Banco Bilbao Vizcaya Argentaria S.A.
BANCO DE ORO UNIBANK, INC.
BANCO SANTANDER, S.A.
Bangkok Bank Public Company Limited
Bank of America, National Association
Bank of Baroda
Bank of China Limited
Bank of Communications Co., Ltd.
Bank of India
Bank of Montreal
BANK OF NEW YORK MELLON (THE)
Bank of Nova Scotia (The)
BANK OF SINGAPORE LIMITED
BANK OF TAIWAN
Bank of Tokyo-Mitsubishi UFJ, Ltd. (The)
Bank Julius Baer & Co. Ltd.
Bank Sarasin & Cie AG
BANK SINOPAC
Barclays Bank PLC
Banque Privée Edmond de Rothschild SA #
BNP PARIBAS
BNP PARIBAS SECURITIES SERVICES
BNP PARIBAS WEALTH MANAGEMENT
BSI LTD #
Canadian Imperial Bank of Commerce
CANARA BANK
CATHAY BANK
CATHAY UNITED BANK COMPANY, LIMITED
Chang Hwa Commercial Bank Ltd.
Chiba Bank, Ltd. (The)
China Construction Bank Corporation
CHINA DEVELOPMENT BANK CORPORATION
China Merchants Bank Co., Ltd.
Chinatrust Commercial Bank, Ltd.
Chugoku Bank, Ltd. (The)
Citibank, N.A.
Commerzbank AG
Commonwealth Bank of Australia
Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.
Coutts & Co AG
also known as :
Coutts & Co SA
Coutts & Co Ltd
(formerly known as
RBS Coutts Bank AG
also known as:
RBS Coutts Bank SA
RBS Coutts Bank Ltd)
CREDIT AGRICOLE CORPORATE AND INVESTMENT BANK
Crédit Agricole (Suisse) SA #
Credit Suisse AG
DBS BANK LTD.
Deutsche Bank Aktiengesellschaft
DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main
E.Sun Commercial Bank, Ltd.

Addition in 2011

Annex Authorized Institutions and Local Representative Offices at 31 December 2011 (continued)

EAST WEST BANK

EFG Bank AG
also known as:
EFG Bank SA
EFG Bank Ltd

ERSTE GROUP BANK AG

Falcon Private Bank AG
also known as:
Falcon Private Bank Ltd.
Falcon Private Bank SA

FAR EASTERN INTERNATIONAL BANK

First Commercial Bank, Ltd.

Hachijuni Bank, Ltd. (The)

HANA BANK

HDFC BANK LIMITED

HONG LEONG BANK BERHAD

HSBC BANK INTERNATIONAL LIMITED

HSBC Bank plc

HSBC Bank USA, National Association

HSBC Private Bank (Suisse) SA

Hua Nan Commercial Bank, Ltd.

ICICI BANK LIMITED

Indian Overseas Bank

Industrial and Commercial Bank of China Limited

Industrial Bank of Korea

Industrial Bank of Taiwan Co., Ltd.

ING Bank N.V.

INTESA SANPAOLO SPA

Iyo Bank, Ltd. (The)

JPMorgan Chase Bank, National Association

KBC Bank N.V.

Korea Exchange Bank

Land Bank of Taiwan Co., Ltd.

LLOYDS TSB BANK plc

LGT Bank in Liechtenstein AG #
also known as:
LGT Bank in Liechtenstein Ltd.
LGT Banque de Liechtenstein S.A.
LGT Banca di Liechtenstein S.A.

MACQUARIE BANK LIMITED #

Malayan Banking Berhad

MEGA INTERNATIONAL COMMERCIAL BANK CO., LTD.

MELLI BANK PLC

Mitsubishi UFJ Trust and Banking Corporation

Mizuho Corporate Bank, Ltd.

National Australia Bank, Limited

NATIONAL BANK OF ABU DHABI

National Bank of Pakistan

NATIXIS

NEWEDGE GROUP

Oversea-Chinese Banking Corporation Limited

Philippine National Bank

PT. Bank Negara Indonesia (Persero) Tbk.

Punjab National Bank

Royal Bank of Canada

Royal Bank of Scotland N.V. (The)

Royal Bank of Scotland public limited company (The)

Shanghai Commercial & Savings Bank, Ltd. (The)

Shanghai Pudong Development Bank Co., Ltd. #

Shiga Bank, Ltd. (The)

Shinhan Bank

Shizuoka Bank, Ltd. (The)

Skandinaviska Enskilda Banken AB #

Societe Generale

SOCIETE GENERALE BANK & TRUST

STANDARD BANK PLC #

Standard Chartered Bank

State Bank of India

State Street Bank and Trust Company

Sumitomo Mitsui Banking Corporation

Svenska Handelsbanken AB (publ)

TAIPEI FUBON COMMERCIAL BANK CO., LTD.

TAISHIN INTERNATIONAL BANK CO., LTD

Taiwan Business Bank

Taiwan Cooperative Bank, Ltd.

Taiwan Shin Kong Commercial Bank Co., Ltd.

Toronto-Dominion Bank

UBS AG
also known as:
UBS SA
UBS Ltd

UCO Bank

UniCredit Bank AG

Union Bank of India

United Overseas Bank Ltd.

Wells Fargo Bank, National Association

WestLB AG

Westpac Banking Corporation

Woori Bank

Deletion in 2011

Fortis Bank

UNICREDIT, SOCIETA' PER AZIONI

Addition in 2011

RESTRICTED LICENCE BANKS

Incorporated in Hong Kong

ALLIED BANKING CORPORATION (HONG KONG) LIMITED

Banc of America Securities Asia Limited

Bank of China International Limited

CHINA CONSTRUCTION BANK (ASIA) FINANCE LIMITED

Citicorp International Limited

J.P. MORGAN SECURITIES (ASIA PACIFIC) LIMITED

KDB Asia Limited

KOOKMIN BANK HONG KONG LIMITED

ORIX ASIA LIMITED

SCOTIABANK (HONG KONG) LIMITED

Societe Generale Asia Limited

UBAF (Hong Kong) Limited

Incorporated outside Hong Kong

Bank of Ayudhya Public Company Limited

BANK MORGAN STANLEY AG #

EUROCLEAR BANK

Mashreq Bank - Public Shareholding Company also known as Mashreqbank psc

PT. BANK MANDIRI (PERSERO) Tbk

RBC Dexia Investor Services Bank S.A.

Siam Commercial Bank Public Company Limited (The)

Thanakharn Kasikorn Thai Chamkat (Mahachon) also known as KASIKORNBANK PUBLIC COMPANY LIMITED

Deletion in 2011

Credit Agricole (Suisse) SA

TMB Bank Public Company Limited

Addition in 2011

DEPOSIT-TAKING COMPANIES

Incorporated in Hong Kong

BCOM Finance (Hong Kong) Limited
BPI International Finance Limited
Chau's Brothers Finance Company Limited
Chong Hing Finance Limited
Commonwealth Finance Corporation Limited
Corporate Finance (D.T.C.) Limited
FUBON CREDIT (HONG KONG) LIMITED
Gunma Finance (Hong Kong) Limited
Habib Finance International Limited
Hachijuni Asia Limited
HBZ Finance Limited
Henderson International Finance Limited
HKCB Finance Limited
Hung Kai Finance Company Limited
Inchroy Credit Corporation Limited
KEB Asia Finance Limited
KEXIM ASIA LIMITED
OCTOPUS CARDS LIMITED
ORIENT FIRST CAPITAL LIMITED
PrimeCredit Limited
PUBLIC FINANCE LIMITED
SHINHAN ASIA LIMITED
Sumitomo Trust Finance (H.K.) Limited (The)
Vietnam Finance Company Limited
Wing Hang Finance Company Limited
WOORI GLOBAL MARKETS ASIA LIMITED

Incorporated outside Hong Kong

NIL

Annex Authorized Institutions and Local Representative Offices at 31 December 2011 (continued)

LOCAL REPRESENTATIVE OFFICES

ANTWERPSE DIAMANTBANK NV
also known as
ANTWERP DIAMOND BANK NV

BANCA POPOLARE COMMERCIO E INDUSTRIA SPA

Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l.

Banca Popolare di Ancona Societa' per azioni

Banca Popolare di Bergamo S.p.A.

Banca Popolare di Sondrio Soc. Coop. a r.l.

BANCA POPOLARE DI VICENZA - Società cooperativa per azioni

Banca Regionale Europea S.p.A.

Banco di Brescia S.p.A.

Banco do Brasil S.A.

Banco Popolare- Societa' Cooperativa

Bank Hapoalim (Switzerland) Ltd

Bank Leumi Le-Israel B.M.

BANK OF BEIJING CO., LTD.

Bank of Fukuoka, Ltd. (The)

Bank of Kyoto, Ltd. (The)

Bank of Yokohama, Ltd. (The)

Banque Cantonale de Genève

BANQUE DEGROOF LUXEMBOURG S.A. #

Banque Transatlantique S.A. #

China Everbright Bank Co., Ltd

CHINA GUANGFA BANK CO., LTD. (formerly known as GUANGDONG DEVELOPMENT BANK CO., LTD.)

CHINA MINSHENG BANKING CORPORATION LIMITED

CLEARSTREAM BANKING S.A.

Corporation Bank

Credit Industriel et Commercial

Credito Bergamasco S.p.A.

Fiduciary Trust Company International

Habib Bank A.G. Zurich

HSH Nordbank AG

Investec Bank Limited

JAPAN POST BANK CO., LTD. #

Joint Stock Company TRASTA KOMERCBANKA #

Juroku Bank, Ltd. (The)

Korea Development Bank (The)

LLOYDS TSB OFFSHORE LIMITED

Merrill Lynch Bank (Suisse) S.A.

Metropolitan Bank and Trust Company

Nanto Bank, Ltd. (The)

National Bank of Canada

Nishi-Nippon City Bank, Ltd. (The)

Norinchukin Bank (The)

Ogaki Kyoritsu Bank, Ltd. (The)

Oita Bank, Ltd. (The)

P.T. Bank Central Asia

P.T. Bank Rakyat Indonesia (Persero)

Raiffeisen Bank International AG

Resona Bank, Limited

Rothschild Bank AG

Schroder & Co Bank AG
also known as:
Schroder & Co Banque SA
Schroder & Co Banca SA
Schroder & Co Bank Ltd
Schroder & Co Banco SA

Shenzhen Development Bank Co., Ltd.

Shinkin Central Bank

Shoko Chukin Bank, Ltd. (The)

Silicon Valley Bank

Union Bank of Taiwan

Unione di Banche Italiane Società Cooperativa per Azioni

Veneto Banca S.c.a.r.l.

Verwaltungs- und Privat-Bank Aktiengesellschaft

Yamaguchi Bank, Ltd. (The)

Yamanashi Chuo Bank, Ltd.

Yuanta Commercial Bank Co., Ltd

Deletion in 2011

BANIF - BANCO INTERNACIONAL DO FUNCHAL, S.A.

Banque Privee Edmond de Rothschild S.A.

BARCLAYS BANK (SUISSE) S.A.

BSI LTD

D.A.H. Hambros Bank (Channel Islands) Limited

HSBC Bank Canada

HSBC Trinkaus & Burkhardt (International) S.A.

Japan Finance Corporation (traded as Japan Bank for International Cooperation)

LGT Bank in Liechtenstein AG
also known as:
LGT Bank in Liechtenstein Ltd.
LGT Banque de Liechtenstein S.A.
LGT Banca di Liechtenstein S.A.

Shanghai Pudong Development Bank Co., Ltd.

Addition in 2011

Table A Major Economic Indicators

		2007	2008	2009	2010	**2011**
I.	**Gross Domestic Product**					
	Real GDP growth (%)	6.4	2.3	(2.6)	7.0	**5.0** [a]
	Nominal GDP growth (%)	9.5	3.8	(3.2)	7.3	**8.7** [a]
	Real growth of major expenditure components of GDP (%)					
	– Private consumption expenditure	8.5	2.4	0.7	6.7	**8.6** [a]
	– Government consumption expenditure	3.0	1.8	2.4	2.8	**1.8** [a]
	– Gross domestic fixed capital formation	3.4	1.0	(3.9)	7.7	**7.2** [a]
	of which					
	– Building and construction	(0.3)	6.8	(5.5)	5.6	**4.6** [a]
	– Machinery, equipment and computer software	3.0	(0.7)	(2.9)	6.4	**13.7** [a]
	– Exports	8.3	2.6	(10.1)	16.7	**4.1** [a]
	– Imports	9.1	2.3	(9.0)	17.3	**4.7** [a]
	GDP at current market prices (US$ billion)	207.1	215.4	209.3	224.2	**243.3** [a]
	Per capita GDP at current market prices (US$)	29,943	30,954	30,018	31,914	**34,405** [a]
II.	**External Trade (HK$ billion)**					
	Merchandise trade [b]					
	– Domestic exports of goods	117.2	101.7	76.4	82.2	**86.9** [a]
	– Re-exports of goods	2,581.7	2,742.3	2,418.3	2,979.1	**3,322.3** [a]
	– Imports of goods	2,852.5	3,024.1	2,703.0	3,395.1	**3,845.9** [a]
	– Merchandise trade balance	(153.7)	(180.1)	(208.2)	(333.8)	**(436.8)** [a]
	Services trade					
	– Exports of services	660.8	718.6	669.8	824.8	**941.3** [a]
	– Imports of services	332.2	366.5	340.6	396.3	**434.9** [a]
	– Services trade balance	328.6	352.1	329.2	428.5	**506.4** [a]
III.	**Fiscal Expenditure and Revenue (HK$ million, fiscal year)**					
	Total government expenditure [c]	234,815	315,112	292,525	301,360	**366,411** [a]
	Total government revenue	358,465	316,562	318,442	376,481	**433,129** [a]
	Consolidated surplus/deficit	123,650	1,450	25,917	75,121	**66,718** [a]
	Reserve balance as at end of fiscal year [d]	492,914	494,364	520,281	595,402	**662,120** [a]
IV.	**Prices (annual change, %)**					
	Consumer Price Index (A)	1.3	3.6	0.4	2.7	**5.6**
	Composite Consumer Price Index	2.0	4.3	0.5	2.4	**5.3**
	Trade Unit Value Indices					
	– Domestic exports	0.8	5.1	(0.2)	5.5	**6.4**
	– Re-exports	2.4	3.8	1.2	4.6	**8.0**
	– Imports	2.3	4.4	(0.1)	6.4	**8.1**
	Property Price Indices					
	– Residential flats	11.7	16.5	0.6	24.4	**20.6** [a]
	– Office premises	18.8	20.3	(9.7)	28.1	**29.3** [a]
	– Retail premises	12.4	11.4	0.5	33.2	**26.5** [a]
	– Flatted factory premises	25.9	18.2	(8.3)	31.5	**35.3** [a]

Table A Major Economic Indicators (continued)

		2007	2008	2009	2010	**2011**
V.	**Labour**					
	Labour force (annual change, %)	1.4	0.4	0.6	(0.8)	**2.0**
	Employment (annual change, %)	2.2	0.9	(1.2)	0.2	**2.9**
	Unemployment rate (annual average, %)	4.0	3.5	5.3	4.3	**3.4**
	Underemployment rate (annual average, %)	2.2	1.9	2.3	2.0	**1.7**
	Employment ('000)	3,477	3,509	3,468	3,474	**3,576**
VI.	**Money Supply (HK$ billion)**					
	HK$ money supply					
	– M1	454.3	491.1	671.2	730.1	**794.7**
	– M2 [e]	3,281.0	3,239.9	3,587.7	3,866.8	**4,046.2**
	– M3 [e]	3,300.5	3,261.3	3,604.8	3,878.2	**4,055.4**
	Total money supply					
	– M1	616.7	645.8	901.8	1,017.2	**1,127.3**
	– M2	6,106.3	6,268.1	6,602.3	7,136.3	**8,057.7**
	– M3	6,139.8	6,300.8	6,626.8	7,156.3	**8,081.3**
VII.	**Interest Rates (end of period, %)**					
	Three-month interbank rate	3.31	0.89	0.13	0.33	**0.33**
	Savings deposit	1.26	0.01	0.01	0.01	**0.01**
	One-month time deposit	1.61	0.04	0.01	0.01	**0.01**
	Banks' 'Best lending rate'	6.75	5.00	5.00	5.00	**5.00**
	Banks' 'Composite rate'	2.29	0.68	0.11	0.21	**0.53**
VIII.	**Exchange Rates (end of period)**					
	HK$/US$	7.802	7.751	7.756	7.775	**7.766**
	Trade-weighted Effective Exchange Rate Index (Jan 2010 = 100)	102.5	102.1	100.3	96.3	**94.9**
IX.	**Foreign Currency Reserve Assets (US$ billion)** [f]	152.7	182.5	255.8	268.7	**285.4**
X.	**Stock Market (end of period figures)**					
	Hang Seng Index	27,813	14,387	21,873	23,035	**18,434**
	Average price/earnings ratio	22.5	7.3	18.1	16.7	**9.7**
	Market capitalisation (HK$ billion)	20,536.5	10,253.6	17,769.3	20,942.3	**17,452.7**

(a) The estimates are preliminary.
(b) Includes non-monetary gold.
(c) Includes repayment of bonds and notes issued in July 2004.
(d) Includes changes in provision for loss in investments with the Exchange Fund.
(e) Adjusted to include foreign currency swap deposits.
(f) Excludes unsettled forward transactions but includes gold.

Table B Performance Ratios of the Banking Sector [a]

	All Authorized Institutions				
	2007 %	2008 %	2009 %	2010 %	**2011** **%**
Asset Quality [b]					
As % of total credit exposures [c]					
Total outstanding provisions/impairment allowances	0.35	0.66	0.63	0.47	**0.43**
Classified [d] exposures:					
– Gross	0.48	0.83	1.10	0.60	**0.49**
– Net of specific provisions/individual impairment allowances	0.32	0.39	0.71	0.34	**0.28**
– Net of all provisions/impairment allowances	0.13	0.17	0.47	0.14	**0.06**
As % of total loans					
Total outstanding provisions/impairment allowances	0.59	0.88	0.96	0.71	**0.63**
Classified [d] loans:					
– Gross	0.75	1.23	1.61	0.83	**0.69**
– Net of specific provisions/individual impairment allowances	0.52	0.75	1.07	0.46	**0.40**
– Net of all provisions/impairment allowances	0.16	0.35	0.65	0.13	**0.05**
Overdue > 3 months and rescheduled loans	0.51	0.69	0.92	0.58	**0.47**
Profitability					
Return on assets (operating profit)	1.37	0.59	0.73	0.82	**0.81**
Return on assets (post-tax profit)	1.21	0.49	0.64	0.76	**0.72**
Net interest margin	1.32	1.30	1.11	1.02	**0.98**
Cost-to-income ratio	46.7	55.6	58.0	58.0	**55.4**
Bad debt charge to total assets	0.04	0.18	0.13	0.05	**0.07**
Liquidity					
Loan to deposit ratio (all currencies)	50.5	54.2	51.5	61.6	**66.9**
Loan to deposit [e] ratio (Hong Kong dollar)	71.0	77.6	71.2	78.1	**84.5**

Asset Quality	
Delinquency ratio of residential mortgage loans	
Credit card receivables	
– Delinquency ratio	
– Charge-off ratio	

Profitability	
Operating profit to shareholders' funds	
Post-tax profit to shareholders' funds	
Capital Adequacy	
Equity to assets ratio [b]	

Capital Adequacy Ratio (Consolidated) [f]	

(a) Figures are related to Hong Kong office(s) only unless otherwise stated.

(b) Figures are related to Hong Kong office(s). For the locally incorporated AIs, figures include their overseas branches.

(c) Credit exposures include loans and advances, acceptances and bills of exchange held, investment debt securities issued by others, accrued interest, and commitments and contingent liabilities to or on behalf of non-banks.

(d) Denotes loans or exposures graded as "substandard", "doubtful" or "loss" in the HKMA's Loan Classification System.

(e) Includes swap deposits.

(f) From 1 January 2007, all locally incorporated AIs started to report their capital adequacy positions according to the Banking (Capital) Rules (i.e. the Basel II framework).

	Retail Banks				
	2007 %	2008 %	2009 %	2010 %	**2011 %**
	0.33	0.64	0.56	0.39	**0.33**
	0.54	0.85	1.00	0.57	**0.42**
	0.38	0.42	0.66	0.33	**0.24**
	0.21	0.21	0.44	0.18	**0.09**
	0.55	0.79	0.84	0.59	**0.50**
	0.85	1.24	1.38	0.77	**0.59**
	0.65	0.84	0.92	0.45	**0.35**
	0.30	0.45	0.54	0.18	**0.09**
	0.57	0.67	0.88	0.60	**0.49**
	1.66	1.02	1.09	1.11	**1.11**
	1.48	0.88	0.97	1.01	**1.01**
	1.90	1.84	1.48	1.32	**1.25**
	40.4	45.3	49.7	49.9	**46.8**
	0.04	0.18	0.11	0.03	**0.03**
	45.5	47.3	46.3	52.8	**55.3**
	65.1	69.4	65.2	70.5	**76.2**

	Surveyed Institutions				
	2007 %	2008 %	2009 %	2010 %	**2011 %**
	0.11	0.05	0.03	0.01	**0.01**
	0.35	0.34	0.34	0.20	**0.19**
	2.90	2.72	3.71	1.91	**1.49**

	Locally Incorporated Licensed Banks				
	2007 %	2008 %	2009 %	2010 %	**2011 %**
	23.8	15.1	16.1	15.5	**16.8**
	21.3	13.0	14.4	14.1	**15.4**
	8.2	7.2	8.5	8.3	**7.9**

	All Locally Incorporated Authorized Institutions				
	2007 %	2008 %	2009 %	2010 %	**2011 %**
	13.4	14.7	16.8	15.8	**15.8**

Table C Authorized Institutions: Domicile and Parentage

	2007	2008	2009	2010	**2011**
Licensed Banks					
(i) Incorporated in Hong Kong	23	23	23	23	**23**
(ii) Incorporated outside Hong Kong	119	122	122	123	**129**
Total	142	145	145	146	**152**
Restricted Licence Banks					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	0	0	1	1	**1**
(b) incorporated outside Hong Kong	8	6	5	5	**5**
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	18	17	16	13	**12**
(iii) Bank related	0	0	1	1	**1**
(iv) Others	3	4	3	1	**1**
Total	29	27	26	21	**20**
Deposit-taking Companies					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	5	7	7	6	**6**
(b) incorporated outside Hong Kong	3	3	4	4	**4**
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	10	8	7	7	**7**
(iii) Bank related	3	2	2	2	**2**
(iv) Others	8	8	8	7	**7**
Total	29	28	28	26	**26**
All Authorized Institutions	200	200	199	193	**198**
Local Representative Offices	79	71	71	67	**61**

Table D Authorized Institutions: Region/Economy of Beneficial Ownership

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	07	08	09	10	**11**	07	08	09	10	**11**	07	08	09	10	**11**
Asia & Pacific															
Hong Kong	11	10	10	10	**10**	–	–	–	–	**–**	10	9	9	7	**7**
Australia	4	4	4	4	**5**	–	–	–	–	**–**	–	–	–	–	**–**
Mainland China	12	13	14	14	**15**	2	1	2	2	**2**	2	3	3	2	**2**
India	11	11	12	12	**12**	–	–	–	–	**–**	1	1	1	1	**1**
Indonesia	1	1	1	1	**1**	2	2	1	1	**1**	–	–	–	–	**–**
Japan	11	11	10	10	**10**	2	2	2	1	**1**	3	3	3	3	**3**
Malaysia	4	4	3	3	**3**	1	1	1	–	**–**	1	1	1	1	**1**
Pakistan	1	1	1	1	**1**	–	–	–	–	**–**	2	2	2	2	**2**
Philippines	2	2	2	2	**2**	1	1	1	1	**1**	3	3	2	2	**2**
Singapore	4	4	4	5	**5**	–	–	–	–	**–**	–	–	–	–	**–**
South Korea	3	5	5	5	**5**	4	2	2	2	**2**	3	3	4	4	**4**
Taiwan	17	18	18	19	**19**	–	–	–	–	**–**	1	1	1	1	**1**
Thailand	1	1	1	1	**1**	4	4	4	4	**3**	–	–	–	–	**–**
Vietnam	–	–	–	–	**–**	–	–	–	–	**–**	1	1	1	1	**1**
Sub-total	82	85	85	87	**89**	16	13	13	11	**10**	27	27	27	24	**24**
Europe															
Austria	1	1	1	1	**1**	–	–	–	–	**–**	–	–	–	–	**–**
Belgium	2	2	2	1	**1**	–	1	1	1	**1**	–	–	–	–	**–**
Denmark	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
France	7	7	8	9	**9**	3	3	3	3	**2**	–	–	–	–	**–**
Germany	8	7	5	4	**4**	–	–	–	–	**–**	–	–	–	–	**–**
Italy	4	4	4	4	**4**	–	–	–	–	**–**	–	–	–	–	**–**
Luxembourg	–	–	–	–	**–**	1	1	1	1	**1**	–	–	–	–	**–**
Netherlands	3	4	5	4	**4**	–	–	–	–	**–**	–	–	–	–	**–**
Spain	2	2	2	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Sweden	1	1	1	1	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Switzerland	3	3	3	4	**5**	–	–	–	–	**–**	–	–	–	–	**–**
United Kingdom	10	11	10	11	**11**	1	1	1	–	**–**	–	–	–	1	**1**
Sub-total	41	42	41	41	**43**	5	6	6	5	**4**	–	–	–	1	**1**
Middle East															
Bahrain	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
Iran	1	1	1	1	**1**	–	–	–	–	**–**	–	–	–	–	**–**
United Arab Emirates	–	–	2	2	**2**	1	1	1	1	**1**	–	–	–	–	**–**
Sub-total	1	1	3	3	**3**	1	1	1	1	**1**	–	–	–	–	**–**
North America															
Canada	5	5	5	5	**5**	1	1	1	1	**1**	–	–	–	–	**–**
United States	12	11	10	9	**9**	6	6	5	3	**4**	1	1	1	1	**1**
Sub-total	17	16	15	14	**14**	7	7	6	4	**5**	1	1	1	1	**1**
South Africa	1	1	1	1	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Bermuda	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
Others	–	–	–	–	**1**	–	–	–	–	**–**	1	–	–	–	**–**
Grand Total	142	145	145	146	**152**	29	27	26	21	**20**	29	28	28	26	**26**

Table E Presence of World's Largest 500 Banks in Hong Kong

Positions at 31.12.2011	Number of Overseas Banks [b]					Licensed Banks [c]				
	07	08	09	10	**11**	07	08	09	10	**11**
World Ranking [a]										
1 – 20	20	20	20	20	**20**	33	35	37	38	**40**
21 – 50	22	23	22	23	**26**	22	22	22	24	**21**
51 – 100	26	26	28	27	**27**	19	23	21	17	**21**
101 – 200	38	35	31	30	**40**	25	21	15	17	**23**
201 – 500	46	55	52	51	**43**	23	27	28	30	**24**
Sub-total	152	159	153	151	**156**	122	128	123	126	**129**
Others	59	46	52	48	**43**	20	17	22	20	**23**
Total	211	205	205	199	**199**	142	145	145	146	**152**

(a) Top 500 banks/banking groups in the world ranked by total assets. Figures are extracted from *The Banker*, July 2011 issue.

(b) The sum of the number of licensed banks, restricted licence banks, deposit-taking companies and local representative offices exceeds the number of overseas banks with presence in Hong Kong due to the multiple presence of some of the overseas banks.

(c) Consist of branches and subsidiaries of overseas banks.

Restricted Licence Banks [c]					Deposit-Taking Companies [c]					Local Representative Offices				
07	08	09	10	**11**	07	08	09	10	**11**	07	08	09	10	**11**
7	6	8	6	**6**	–	–	–	–	**–**	6	6	5	5	**3**
5	5	4	3	**3**	–	–	1	2	**2**	5	5	4	3	**5**
2	1	1	1	**1**	5	6	5	3	**3**	9	3	14	16	**14**
1	1	0	0	**0**	3	2	3	3	**4**	15	14	15	12	**14**
6	8	8	6	**5**	1	1	1	1	**2**	19	22	18	16	**14**
21	21	21	16	**15**	9	9	10	9	**11**	54	50	56	52	**50**
8	6	5	5	**5**	20	19	18	17	**15**	25	21	15	15	**11**
29	27	26	21	**20**	29	28	28	26	**26**	79	71	71	67	**61**

Table F Balance Sheet: All Authorized Institutions and Retail Banks

All Authorized Institutions

(HK$ billion)	2007 HK$	2007 F/CY	2007 Total	2008 HK$	2008 F/CY	2008 Total
Assets						
Loans to customers	2,185	777	2,962	2,355	931	3,286
– Inside Hong Kong [a]	2,057	400	2,457	2,201	509	2,710
– Outside Hong Kong [b]	128	377	504	154	422	575
Interbank lending	797	3,714	4,510	542	3,483	4,025
– Inside Hong Kong	346	269	615	261	287	548
– Outside Hong Kong	451	3,444	3,895	281	3,195	3,477
Negotiable certificates of deposit (NCDs)	66	28	93	39	49	88
Negotiable debt instruments, other than NCDs	499	1,190	1,688	392	1,433	1,825
Other assets	529	567	1,096	605	926	1,531
Total Assets	4,075	6,275	10,350	3,933	6,821	10,754
Liabilities						
Deposits from customers [c]	3,075	2,794	5,869	3,034	3,024	6,058
Interbank borrowing	605	2,357	2,961	447	2,498	2,945
– Inside Hong Kong	353	277	630	262	292	555
– Outside Hong Kong	251	2,080	2,331	185	2,205	2,390
Negotiable certificates of deposit	122	49	172	86	22	108
Other liabilities	852	497	1,348	779	864	1,643
Total Liabilities	4,653	5,697	10,350	4,347	6,407	10,754

Retail Banks

(HK$ billion)	2007 HK$	2007 F/CY	2007 Total	2008 HK$	2008 F/CY	2008 Total
Assets						
Loans to customers	1,742	279	2,021	1,870	366	2,236
– Inside Hong Kong [a]	1,675	190	1,865	1,787	258	2,044
– Outside Hong Kong [b]	67	89	156	83	108	191
Interbank lending	470	1,367	1,837	368	1,205	1,573
– Inside Hong Kong	269	155	424	200	172	372
– Outside Hong Kong	201	1,211	1,413	168	1,034	1,201
Negotiable certificates of deposit (NCDs)	47	13	60	27	25	52
Negotiable debt instruments, other than NCDs	378	778	1,156	293	1,074	1,367
Other assets	391	328	719	457	602	1,060
Total Assets	3,029	2,764	5,793	3,014	3,273	6,288
Liabilities						
Deposits from customers [c]	2,674	1,763	4,437	2,695	2,036	4,731
Interbank borrowing	138	297	435	118	356	474
– Inside Hong Kong	69	44	114	52	72	124
– Outside Hong Kong	69	253	322	66	284	350
Negotiable certificates of deposit	67	37	104	40	13	53
Other liabilities	641	176	817	566	464	1,029
Total Liabilities	**3,519**	**2,274**	**5,793**	**3,420**	**2,868**	**6,288**

(a) Defined as loans for use in Hong Kong plus trade finance.

(b) Includes "others" (i.e. unallocated).

(c) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total because of rounding.

2009			2010			**2011**		
HK$	F/CY	Total	HK$	F/CY	Total	**HK$**	**F/CY**	**Total**
2,401	887	3,288	2,824	1,403	4,228	**3,160**	**1,921**	**5,081**
2,227	419	2,646	2,568	695	3,262	**2,811**	**906**	**3,717**
174	468	642	257	708	965	**349**	**1,014**	**1,363**
475	3,282	3,757	399	3,743	4,142	**352**	**4,127**	**4,479**
231	317	548	181	473	654	**205**	**443**	**648**
244	2,966	3,209	218	3,270	3,488	**147**	**3,684**	**3,831**
41	62	102	80	54	133	**90**	**104**	**194**
816	1,541	2,357	893	1,737	2,630	**862**	**1,857**	**2,719**
666	465	1,131	550	608	1,158	**566**	**704**	**1,270**
4,399	6,236	10,635	4,746	7,545	12,291	**5,029**	**8,712**	**13,741**
3,374	3,007	6,381	3,617	3,245	6,862	**3,740**	**3,851**	**7,591**
473	2,409	2,882	466	3,222	3,688	**545**	**3,481**	**4,026**
228	321	549	178	478	657	**199**	**450**	**649**
245	2,088	2,332	288	2,744	3,032	**346**	**3,031**	**3,377**
69	27	96	114	61	175	**144**	**239**	**383**
762	515	1,277	845	720	1,565	**913**	**829**	**1,741**
4,678	5,958	10,635	5,043	7,248	12,291	**5,341**	**8,400**	**13,741**

2009			2010			**2011**		
HK$	F/CY	Total	HK$	F/CY	Total	**HK$**	**F/CY**	**Total**
1,963	352	2,315	2,310	622	2,932	**2,567**	**784**	**3,351**
1,857	229	2,086	2,150	392	2,542	**2,348**	**463**	**2,812**
106	123	229	160	230	391	**219**	**321**	**540**
263	1,162	1,425	172	1,439	1,611	**172**	**1,638**	**1,810**
168	186	353	112	284	396	**123**	**203**	**326**
96	976	1,072	60	1,155	1,215	**49**	**1,435**	**1,484**
28	30	58	54	27	81	**57**	**47**	**104**
692	1,104	1,795	620	1,257	1,876	**620**	**1,315**	**1,934**
477	292	769	432	396	828	**438**	**470**	**908**
3,424	2,940	6,364	3,588	3,740	7,328	**3,855**	**4,253**	**8,108**
3,012	1,992	5,004	3,276	2,280	5,556	**3,367**	**2,692**	**6,059**
165	265	430	136	486	622	**162**	**523**	**685**
42	83	124	41	291	332	**53**	**246**	**299**
123	182	305	95	195	290	**109**	**277**	**386**
25	11	36	41	22	63	**64**	**99**	**163**
625	269	894	682	406	1,088	**722**	**478**	**1,200**
3,827	**2,536**	**6,364**	**4,134**	**3,194**	**7,328**	**4,316**	**3,792**	**8,108**

Table G Major Balance Sheet Items by Region/Economy of Beneficial Ownership of Authorized Institutions

(HK$ billion)		Mainland China	Japan	US	Europe	Others	Total
Total Assets	2010	2,748	756	835	3,022	4,929	12,291
	2011	**3,448**	**897**	**1,055**	**2,782**	**5,559**	**13,741**
Deposits from Customers [a]	2010	1,701	151	361	1,181	3,469	6,862
	2011	**2,062**	**166**	**376**	**1,283**	**3,705**	**7,591**
Loans to Customers	2010	1,191	258	107	768	1,903	4,228
	2011	**1,437**	**375**	**183**	**855**	**2,230**	**5,081**
Loans to Customers	2010	905	175	98	486	1,598	3,262
Inside Hong Kong [b]	**2011**	**1,045**	**244**	**158**	**538**	**1,733**	**3,717**
Loans to Customers	2010	286	83	10	282	304	965
Outside Hong Kong [c]	**2011**	**392**	**131**	**25**	**318**	**497**	**1,363**

(a) Figures have been revised to include deposits from the Exchange Fund with maturity less than one month.

(b) Defined as loans for use in Hong Kong plus trade finance.

(c) Includes "others" (i.e. unallocated).

Figures may not add up to total because of rounding.

Table H Flow of Funds for All Authorized Institutions and Retail Banks

All Authorized Institutions

Increase/(Decrease) in (HK$ billion)	2010 HK$	2010 F/CY	2010 Total	2011 HK$	2011 F/CY	2011 Total
Assets						
Loans to customers	423	516	939	336	517	853
– Inside Hong Kong [a]	341	275	616	244	211	455
– Outside Hong Kong [b]	82	241	323	92	306	398
Interbank lending	(76)	461	385	(47)	384	337
– Inside Hong Kong	(50)	157	107	24	(30)	(7)
– Outside Hong Kong	(26)	304	278	(71)	414	344
All other assets	(1)	332	331	(5)	266	261
Total Assets	347	1,309	1,655	283	1,167	1,451
Liabilities						
Deposits from customers [c]	244	238	481	123	606	729
Interbank borrowing	(7)	813	807	79	259	338
– Inside Hong Kong	(50)	157	107	20	(28)	(8)
– Outside Hong Kong	43	656	699	59	287	346
All other liabilities	128	239	368	97	287	384
Total Liabilities	365	1,290	1,655	299	1,152	1,451
Net Interbank Borrowing/(Lending)	69	352	422	126	(125)	1
Net Customer Lending/(Borrowing)	180	278	458	213	(88)	124

Retail Banks

Increase/(Decrease) in (HK$ billion)	2010 HK$	2010 F/CY	2010 Total	2011 HK$	2011 F/CY	2011 Total
Assets						
Loans to customers	347	269	617	257	162	419
– Inside Hong Kong [a]	293	163	456	198	72	270
– Outside Hong Kong [b]	54	107	161	59	90	149
Interbank lending	(91)	277	186	0	199	199
– Inside Hong Kong	(55)	98	43	11	(81)	(70)
– Outside Hong Kong	(36)	179	143	(11)	280	269
All other assets	(92)	254	162	9	152	161
Total Assets	164	801	965	266	513	779
Liabilities						
Deposits from customers [c]	264	288	552	92	411	503
Interbank borrowing	(29)	221	192	27	37	63
– Inside Hong Kong	(1)	208	207	12	(45)	(33)
– Outside Hong Kong	(28)	13	(15)	15	82	96
All other liabilities	72	149	221	63	149	212
Total Liabilities	307	658	965	182	597	779
Net Interbank Borrowing/(Lending)	62	(56)	6	27	(162)	(135)
Net Customer Lending/(Borrowing)	84	(19)	65	165	(250)	(84)

(a) Defined as loans for use in Hong Kong plus trade finance.
(b) Includes "others" (i.e. unallocated).
(c) Hong Kong dollar customer deposits include swap deposits.
Figures may not add up to total because of rounding.

Table I Loans to and Deposits from Customers by Category of Authorized Institutions

(HK$ billion)	Loans to Customers				Deposits from Customers [a]			
	HK$	F/CY	Total	%	HK$	F/CY	Total	%
2007								
Licensed banks	2,127	749	2,876	97	3,056	2,782	5,839	99
Restricted licence banks	32	26	59	2	15	9	25	–
Deposit-taking companies	25	2	27	1	3	2	5	–
Total	2,185	777	2,962	100	3,075	2,794	5,869	100
2008								
Licensed banks	2,293	904	3,197	97	3,013	3,013	6,027	99
Restricted licence banks	35	24	59	2	15	9	24	–
Deposit-taking companies	27	3	29	1	6	2	8	–
Total	2,355	931	3,286	100	3,034	3,024	6,058	100
2009								
Licensed banks	2,352	859	3,211	98	3,358	3,000	6,358	100
Restricted licence banks	27	26	53	2	11	6	16	–
Deposit-taking companies	22	3	25	1	5	2	7	–
Total	2,401	887	3,288	100	3,374	3,007	6,381	100
2010								
Licensed banks	2,785	1,386	4,170	99	3,607	3,236	6,844	100
Restricted licence banks	17	14	31	1	6	7	13	–
Deposit-taking companies	23	4	26	1	4	2	6	–
Total	2,824	1,403	4,228	100	3,617	3,245	6,862	100
2011								
Licensed banks	**3,123**	**1,897**	**5,021**	**99**	**3,731**	**3,836**	**7,567**	**100**
Restricted licence banks	**15**	**19**	**34**	**1**	**5**	**12**	**17**	**–**
Deposit-taking companies	**21**	**4**	**26**	**1**	**4**	**2**	**6**	**–**
Total	**3,160**	**1,921**	**5,081**	**100**	**3,740**	**3,851**	**7,591**	**100**

(a) Hong Kong dollar customer deposits include swap deposits.

A "-" sign denotes a figure of less than 0.5.

Figures may not add up to total because of rounding.

Table J Loans to Customers Inside Hong Kong by Economic Sector

All Authorized Institutions

Sector	2007		2008		2009		2010		**2011**	
(HK$ billion)	HK$	%	HK$	%	HK$	%	HK$	%	**HK$**	**%**
Hong Kong's visible trade	183	7	186	7	175	7	274	8	**348**	**9**
Manufacturing	121	5	147	5	127	5	162	5	**194**	**5**
Transport and transport equipment	145	6	155	6	151	6	168	5	**194**	**5**
Building, construction and property development, and investment	578	24	687	25	687	26	827	25	**912**	**25**
Wholesale and retail trade	116	5	152	6	150	6	229	7	**314**	**8**
Financial concerns (other than authorized institutions)	251	10	283	10	186	7	235	7	**273**	**7**
Individuals										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	58	2	57	2	52	2	51	2	**46**	**1**
– to purchase other residential property	564	23	593	22	647	24	745	23	**805**	**22**
– other purposes	221	9	226	8	222	8	256	8	**292**	**8**
Others	220	9	223	8	250	9	315	10	**341**	**9**
Total [a]	2,457	100	2,710	100	2,646	100	3,262	100	**3,717**	**100**

Retail Banks

Sector	2007		2008		2009		2010		**2011**	
(HK$ billion)	HK$	%	HK$	%	HK$	%	HK$	%	**HK$**	**%**
Hong Kong's visible trade	147	8	147	7	131	6	208	8	**242**	**9**
Manufacturing	79	4	97	5	87	4	114	4	**130**	**5**
Transport and transport equipment	87	5	92	4	95	5	102	4	**115**	**4**
Building, construction and property development, and investment	460	25	536	26	556	27	663	26	**714**	**25**
Wholesale and retail trade	78	4	99	5	102	5	161	6	**206**	**7**
Financial concerns (other than authorized institutions)	88	5	106	5	84	4	106	4	**121**	**4**
Individuals										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	58	3	57	3	52	2	51	2	**46**	**2**
– to purchase other residential property	551	30	579	28	634	30	734	29	**794**	**28**
– other purposes	178	10	188	9	186	9	209	8	**245**	**9**
Others	139	7	144	7	159	8	193	8	**198**	**7**
Total [a]	1,865	100	2,044	100	2,086	100	2,542	100	**2,812**	**100**

(a) Defined as loans for use in Hong Kong plus trade finance.

Figures may not add up to total because of rounding.

Table K Deposits from Customers

(HK$ billion)	All Authorized Institutions				Retail banks			
	Demand	Savings	Time	Total	Demand	Savings	Time	Total
Hong Kong Dollar [a]								
2007	296	1,110	1,669	3,075	273	1,096	1,305	2,674
2008	321	1,254	1,459	3,034	295	1,239	1,161	2,695
2009	477	1,767	1,130	3,374	434	1,744	835	3,012
2010	511	1,835	1,270	3,617	462	1,811	1,002	3,276
2011	**546**	**1,671**	**1,523**	**3,740**	**497**	**1,648**	**1,223**	**3,367**
Foreign Currency								
2007	162	520	2,112	2,794	112	451	1,200	1,763
2008	155	691	2,178	3,024	102	610	1,324	2,036
2009	231	932	1,845	3,007	143	828	1,021	1,992
2010	287	1,078	1,880	3,245	181	956	1,143	2,280
2011	**333**	**1,234**	**2,284**	**3,851**	**205**	**1,089**	**1,398**	**2,692**
Total								
2007	459	1,629	3,781	5,869	385	1,547	2,506	4,437
2008	475	1,945	3,637	6,058	397	1,849	2,485	4,731
2009	707	2,699	2,975	6,381	576	2,572	1,856	5,004
2010	798	2,913	3,151	6,862	643	2,768	2,145	5,556
2011	**879**	**2,905**	**3,807**	**7,591**	**702**	**2,737**	**2,621**	**6,059**

(a) Hong Kong dollar customer deposits include swap deposits.

Figures may not add up to total because of rounding.

Table L Geographical Breakdown of Net External Claims/ (Liabilities) of All Authorized Institutions

Region/Economy (HK$ billion)	2010 Net Claims on/ (Liabilities to) Banks Outside Hong Kong	2010 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	2010 Total Net Claims/ (Liabilities)	**2011 Net Claims on/ (Liabilities to) Banks Outside Hong Kong**	**2011 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong**	**2011 Total Net Claims/ (Liabilities)**
Asia and Pacific	1,210	(237)	973	**1,521**	**(112)**	**1,408**
Mainland China	758	(177)	581	**1,172**	**(89)**	**1,083**
Australia	247	54	301	**256**	**51**	**307**
South Korea	218	60	277	**200**	**49**	**250**
India	77	57	134	**61**	**102**	**164**
Indonesia	(7)	(2)	(10)	**7**	**1**	**8**
Malaysia	16	(5)	11	**21**	**(13)**	**8**
Vietnam	3	0	3	**5**	**0**	**6**
Sri Lanka	3	2	4	**3**	**2**	**6**
New Zealand	13	5	18	**5**	**0**	**5**
Bangladesh	2	0	2	**4**	**0**	**4**
Republic of Kazakhstan	1	1	2	**0**	**1**	**2**
Maldives	1	0	2	**1**	**0**	**1**
Singapore	53	(95)	(41)	**106**	**(105)**	**1**
Cambodia	0	0	(1)	**0**	**0**	**0**
Vanuatu	0	0	0	**0**	**(1)**	**(1)**
Myanmar	(1)	0	(1)	**(1)**	**0**	**(1)**
Papua New Guinea	0	(2)	(2)	**0**	**(2)**	**(2)**
Nepal	(3)	0	(3)	**(2)**	**0**	**(2)**
Philippines	(14)	(7)	(21)	**(2)**	**(8)**	**(9)**
Western Samoa	0	(10)	(10)	**0**	**(15)**	**(15)**
Brunei	(7)	(4)	(11)	**(12)**	**(3)**	**(15)**
Thailand	6	(14)	(8)	**5**	**(21)**	**(16)**
Taiwan	51	(174)	(122)	**112**	**(198)**	**(86)**
Macau SAR	(36)	(4)	(40)	**(103)**	**(9)**	**(112)**
Japan	(166)	82	(84)	**(315)**	**146**	**(168)**
Others	(4)	(5)	(9)	**(4)**	**(4)**	**(8)**
North America	(103)	203	100	**(129)**	**160**	**32**
United States	(109)	195	85	**(126)**	**153**	**27**
Canada	6	9	15	**(2)**	**7**	**5**
Caribbean	35	(65)	(30)	**54**	**(66)**	**(12)**
Bahamas	61	(7)	54	**52**	**(7)**	**45**
Cayman Islands	(26)	12	(14)	**2**	**18**	**21**
Panama	1	4	4	**0**	**5**	**5**
Barbados	0	(2)	(2)	**0**	**1**	**1**
Netherlands Antilles	0	1	1	**0**	**0**	**0**
Bermuda	0	(2)	(2)	**0**	**(4)**	**(4)**
Others	0	(71)	(71)	**0**	**(80)**	**(80)**
Africa	0	(4)	(4)	**(1)**	**(3)**	**(4)**
South Africa	2	0	3	**2**	**0**	**2**
Mauritius	(2)	1	(1)	**0**	**2**	**1**
Liberia	0	(3)	(3)	**0**	**0**	**0**
Nigeria	0	0	0	**(1)**	**0**	**(1)**
Others	0	(3)	(3)	**(1)**	**(5)**	**(7)**

Table L Geographical Breakdown of Net External Claims/ (Liabilities) of All Authorized Institutions (continued)

Region/Economy (HK$ billion)	2010 Net Claims on/ (Liabilities to) Banks Outside Hong Kong	2010 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	2010 Total Net Claims/ (Liabilities)	2011 Net Claims on/ (Liabilities to) Banks Outside Hong Kong	2011 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	2011 Total Net Claims/ (Liabilities)
Latin America	4	1	5	**6**	**3**	**9**
Mexico	0	3	3	**1**	**4**	**5**
Brazil	3	(1)	2	**5**	**0**	**5**
Peru	0	1	1	**0**	**2**	**2**
Chile	0	1	1	**0**	**1**	**1**
Venezuela	0	0	0	**0**	**(1)**	**(1)**
Others	0	(3)	(3)	**0**	**(3)**	**(3)**
Eastern Europe	7	0	7	**4**	**(2)**	**3**
Western Europe	437	102	540	**149**	**101**	**250**
United Kingdom	219	(19)	200	**122**	**(3)**	**119**
France	136	44	180	**28**	**41**	**68**
Germany	59	44	103	**29**	**38**	**67**
Switzerland	92	(1)	90	**50**	**(6)**	**44**
Luxembourg	6	3	9	**17**	**1**	**17**
Sweden	5	3	8	**8**	**4**	**12**
Jersey	14	0	14	**7**	**1**	**8**
Netherlands	(7)	15	9	**(8)**	**15**	**7**
Norway	5	0	5	**4**	**2**	**6**
Turkey	2	0	3	**5**	**0**	**5**
Republic of Ireland	1	(1)	0	**0**	**4**	**4**
Denmark	4	8	12	**3**	**0**	**3**
Finland	0	0	0	**2**	**0**	**1**
Iceland	1	0	1	**1**	**0**	**1**
Isle of Man	0	(1)	(1)	**0**	**0**	**0**
Cyprus	0	1	1	**0**	**0**	**0**
Austria	(5)	0	(5)	**(1)**	**0**	**(1)**
Liechtenstein	0	(1)	(1)	**(1)**	**0**	**(1)**
Gibraltar	0	(1)	(1)	**0**	**(1)**	**(1)**
Guernsey	(1)	0	(1)	**0**	**(1)**	**(1)**
Malta	(4)	0	(4)	**(6)**	**0**	**(6)**
Belgium	(8)	0	(7)	**(20)**	**1**	**(20)**
Italy	(44)	4	(40)	**(43)**	**3**	**(40)**
Spain	(37)	3	(34)	**(48)**	**6**	**(41)**
Others	0	(1)	(1)	**0**	**(1)**	**(1)**
Middle East	9	57	65	**(21)**	**60**	**39**
United Arab Emirates	7	25	32	**(5)**	**31**	**26**
Qatar	2	28	30	**1**	**19**	**20**
Saudi Arabia	1	1	3	**1**	**9**	**10**
Egypt	0	1	1	**(1)**	**1**	**1**
Bahrain	(1)	1	0	**0**	**0**	**0**
Israel	0	(1)	(1)	**0**	**(1)**	**(1)**
Oman	(1)	0	(1)	**(3)**	**0**	**(3)**
Kuwait	1	1	2	**(12)**	**(1)**	**(12)**
Others	0	(1)	(1)	**(1)**	**0**	**(1)**
Others [a]	89	4	93	**67**	**5**	**72**
Overall Total	1,689	61	1,749	**1,651**	**146**	**1,797**

(a) "Others" include economies not listed above and positions in relation to international organisations.

Figures may not add up to total because of rounding.

Abbreviations used in this Report

AI	–	Authorized institution
AML	–	Anti-money-laundering
APEC	–	Asia-Pacific Economic Co-operation
ASEAN	–	Association of Southeast Asian Nations
BCR	–	Banking (Capital) Rules
BIS	–	Bank for International Settlements
BLR	–	Best lending rate
CAAP	–	Capital adequacy assessment process
CAMEL	–	Capital adequacy, Asset quality, Management, Earnings and Liquidity
CAR	–	Capital adequacy ratio
CCASS	–	Central Clearing and Settlement System
CCR	–	Counterparty central risk
CEPA	–	Closer Economic Partnership Arrangement
CFT	–	Counter-terrorist-financing
CHATS	–	Clearing House Automated Transfer System
CLS	–	Continuous Linked Settlement
CMIM	–	Chiang Mai Initiative Multilateralisation
CMU	–	Central Moneymarkets Unit
CSDs	–	Central Securities Depositories
CSSO	–	Clearing and Settlement Systems Ordinance
DPS	–	Deposit Protection Scheme
DvP	–	Delivery-versus-Payment
EFAC	–	Exchange Fund Advisory Committee
EFBN	–	Exchange Fund Bills and Notes
EMEAP	–	Executives' Meeting of East Asia-Pacific Central Banks
F/CY	–	Foreign currency
FS	–	Financial Secretary
FSB	–	Financial Stability Board
FSTB	–	Financial Services and the Treasury Bureau
G20	–	Group of Twenty
GDP	–	Gross Domestic Product
GSC	–	Governance Sub-Committee
G-SIBs	–	Global systemically important banks
HIBOR	–	Hong Kong Interbank Offered Rate
HKDPB	–	Hong Kong Deposit Protection Board
HKFRSs	–	Hong Kong Financial Reporting Standards
HKICPA	–	Hong Kong Institute of Certified Public Accountants
HKMA	–	Hong Kong Monetary Authority
HKMC	–	Hong Kong Mortgage Corporation Limited
HKSAR	–	Hong Kong Special Administrative Region
IASB	–	International Accounting Standards Board
iBond	–	Inflation-linked retail bond
ILAS	–	Investment-linked assurance scheme
IPO	–	Initial public offering
IRB approach	–	Internal ratings-based approach
IMM approach	–	Internal models approach
ISC	–	Investment Sub-Committee
LCR	–	Liquidity coverage ratio
MA	–	Monetary Authority
MPF	–	Mandatory Provident Fund
MPFA	–	Mandatory Provident Fund Schemes Authority
NFC	–	Near field communication
NSFR	–	Net stable funding ratio
OCI	–	Office of the Commissioner of Insurance
OECD	–	Organisation for Economic Co-operation and Development
OTC	–	Over-the-counter
PBoC	–	People's Bank of China
PvP	–	Payment-versus-Payment
QIS	–	Quantitative impact study
RMB	–	Renminbi
RMC	–	Risk Management and Compliance Division
RTGS	–	Real Time Gross Settlement
SFC	–	Securities and Futures Commission
SRP	–	Supervisory review process
TMA	–	Treasury Markets Association
TR	–	Trade repository
VaR	–	Value-at-Risk

Reference Resources

The *HKMA Annual Report* is published in April each year. A number of other HKMA publications provide explanatory and background information on the HKMA's policies and functions. These include:

An Introduction to the Hong Kong Monetary Authority

HKMA Quarterly Bulletin (online publication)
(published in March, June, September and December each year)

Monthly Statistical Bulletin (online publication)
(published in two batches on the third and sixth business days of each month)

Guide to Hong Kong Monetary and Banking Terms (Third Edition)

HKMA Background Brief No. 1 – Hong Kong's Linked Exchange Rate System (Second Edition)

HKMA Background Brief No. 2 – Banking Supervision in Hong Kong (Second Edition)

HKMA Background Brief No. 3 – Mandate and Governance of the Hong Kong Monetary Authority

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