HONG KONG MONETARY AUTHORITY
香 港 金 融 管 理 局

ANNUAL REPORT 2012

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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Central,
Hong Kong
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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 2012 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 2012

Economic and Financial Environment

The Hong Kong economy faces strong external headwinds with real GDP growth slowing visibly to 1.4%.

The banking sector remains robust and well capitalised with sound asset quality. Credit growth moderates and liquidity conditions improve.

Monetary Stability

Currency Board operations remain smooth throughout the year despite capital inflows into the Hong Kong dollar towards the end of the year prompting intermittent triggering of the strong-side Convertibility Undertaking. The Hong Kong dollar exchange rate trades within a very narrow band against the US dollar.

Money market activities are orderly with ample interbank liquidity.

Banking Stability

The HKMA extends its vigilance on the management of liquidity and credit risks by banks because of the continuing impact on global financial markets of the European sovereign debt crisis and uncertainty over the US recovery.

The fifth round of countercyclical measures on property mortgage loans is introduced; and supervision of banks' compliance with anti-money laundering requirements is stepped up.

Legislation to implement the first phase of the strengthened Basel standards is enacted to take effect from 1 January 2013.

International Financial Centre

Hong Kong's status as a global centre for offshore renminbi trade settlement, financing and asset management is strengthened. International co-operation platforms with London and Australia are established, and renminbi banking services are extended to non-Hong Kong residents.

The HKMA proactively participates in regional co-operative initiatives to promote monetary and financial stability in Asia and to improve the region's collective voice in international financial affairs. In response to industry demands and international developments, new components are added to further broaden the scope and increase the depth of Hong Kong's financial infrastructure.

Reserves Management

The Exchange Fund records an investment income of $111.6 billion, a return of 4.4%.

Total assets of the Exchange Fund reach $2,781.1 billion at the end of 2012.

Chief Executive's Statement

2012 was an eventful year both in the financial and political contexts. Major elections and changes in governments occurred in different parts of the world. The inconclusive Greek elections in May rekindled concerns not only over the possibility of Greece exiting the euro area, but a collapse of the Eurosystem. As the situation in Europe worsened with market sentiment shrinking, the European Central Bank (ECB) President Mario Draghi said in July that "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." In September, the ECB announced the framework of an unprecedented Outright Monetary Transactions programme, which succeeded in easing the concerns on the tail risk of the euro falling apart, thereby arresting further deterioration in market sentiment. In the same month, the US Federal Open Market Committee (FOMC) announced the third round of quantitative easing, followed by the launch in January 2013 of a further expansion of the scale to US$85 billion a month, without a time limit, until the employment situation in the US substantially improves. In Japan, the newly elected Government announced its plans in November to revitalise the Japanese economy through, amongst other measures, more aggressive quantitative easing by the Bank of Japan.

These developments helped calm global financial markets, resulting in an improvement in market sentiment. With the pick up in investors' risk appetite and with an even larger amount of surplus funds searching for yields, we started to see a revival in the flow of funds into the Hong Kong dollar in the final quarter of 2012. The total amount of inflows through the Currency Board Account was over HK$100 billion, which was smaller in scale than the last wave of inflows of over HK$640 billion registered between the last quarter of 2008 and the end of 2009. The smooth operation of the strong-side Convertibility Undertaking helped demonstrate to the public the Government's commitment and ability to maintain the Link, which is the cornerstone of monetary and financial stability in Hong Kong. Indeed, the International Monetary Fund reaffirmed its strong endorsement of the Link in its annual Article IV Consultation in November stating it remained the most appropriate regime for Hong Kong as a small and open economy.

Given the exceptionally low interest rates in the US and in Hong Kong and the abundance of surplus liquidity globally, overheating of the property market remained the biggest risk to banking and financial stability in Hong Kong. As soon as the FOMC announced its third round of quantitative easing in September, the HKMA launched the fifth round of countercyclical prudential measures to further enhance the risk management and resilience of the banking system. This was followed in October by additional tax measures introduced by the Hong Kong Special Administrative Region Government which together helped reduce the exuberance of the property market for a while. But, as we know, overheating in both the residential and commercial property sectors resumed in January 2013. Nevertheless, the HKMA succeeded in holding back the trend of sharp increases in the growth of general credit in the banking system in 2012, which moderated to a more sustainable level of around 10%, compared with 20% in 2011 and 29% in 2010.

We also enacted new legislation that enabled the HKMA to implement the new capital rules promulgated by the Basel Committee on Banking Supervision, which form the international minimum standards for banks. In June, the HKMA, in collaboration with the Securities and Futures Commission, announced a package of measures to promote and facilitate further development of private banking in Hong Kong. It includes the option to switch from a transaction-by-transaction basis to a portfolio-based approach in ensuring suitability of investment recommendations. The HKMA also encouraged the industry to set up a new private wealth management association to promote industry-wide standards, a code of ethics and an enhanced competency framework for practitioners. Separately, the HKMA continued with its programme to reach out to overseas asset owners and managers to promote Hong Kong as an asset management hub in Asia. These outreaching efforts were favourably received and are producing positive results for Hong Kong.

With the support of the Central People's Government and the ministries concerned, Hong Kong continued to develop and consolidate its position as the global hub for offshore renminbi businesses. As compared with the previous year, the amount of renminbi trade settlement handled by banks in Hong Kong increased by 37% to RMB2.63 trillion, and renminbi bank loans grew 1.6 times to RMB79 billion. The dim sum bond market remained buoyant with a total issuance of RMB112 billion; and with a deposit pool of over RMB700 billion, Hong Kong remained the biggest and most liquid offshore renminbi centre in the world. During the year, the HKMA launched several initiatives to develop Hong Kong as the most open and user-friendly offshore renminbi platform not only for customers based here, but for overseas corporates and banks as well. These included extending the operating hours of the renminbi interbank payment system (renminbi RTGS system) to 15 hours, from 8:30 a.m. to 11:30 p.m. Hong Kong time, enabling customers in the European time zone and early North American business hours to make or receive real-time renminbi payments. At the same time, the HKMA played a leading role in roadshows overseas to promote Hong Kong's renminbi platform, and worked in partnership with the UK Treasury, the Australian Treasury and the Reserve Bank of Australia respectively to set up co-operative forums to help promote the use of Hong Kong in developing offshore renminbi businesses in London and Sydney respectively. As an illustration of the global network that Hong Kong is currently serving, over 1,400 renminbi correspondent bank accounts were opened by overseas banks in Hong Kong and over 200 banks, including some that do not have operations in Hong Kong, have joined our renminbi RTGS system. The average daily turnover jumped significantly from RMB5 billion in 2010 to RMB121 billion in 2011 and further to RMB264 billion in December 2012. It is important to note that, of these payments, only 10% were cross-border flows into or out of the Mainland while the rest were payments to and from offshore entities. This is clear evidence of the rapid development of offshore economic and financial activities involving payments in renminbi.

Benefiting mainly from the improvement in the market sentiment and liquidity driven equity markets globally, the investment income of the Exchange Fund was HK$111.6 billion, the second highest amount in the history of the Fund. The Backing Portfolio, which can only hold highly liquid top quality short-term US papers, achieved a low return of 0.4%. However, the Investment Portfolio achieved a return of 8%, pushing up the overall rate of return for the entire Exchange Fund to 4.4%. I am also pleased to report we have made good progress in diversifying the investments of the Exchange Fund into a Long-Term Growth Portfolio (LTGP) comprising emerging market bonds and equities, renminbi assets, private equity and real estate. At the end of 2012, the value of the invested assets, together with the commitment awaiting draw-downs, was around HK$200 billion. The rate of return of the LTGP since its inception has so far been satisfactory with emerging market bonds and equities, and renminbi assets achieving an annualised rate of return of 8%, and private equity and real estate achieving an annualised internal rate of return of 10%. Towards the end of last year, the HKMA conducted a review of the LTGP investments and the Financial Secretary, on the advice of EFAC, decided to re-group the emerging market bonds and equities, and renminbi assets in the Investment Portfolio, thereby creating further headroom for the LTGP to develop in the years ahead.

Although we entered 2013 with significantly improved market sentiment and investors' risk appetite, there is no room for complacency. Most of the fundamental causes leading to the global imbalances have not been fully addressed while many structural reforms that are needed to bring back fiscal discipline and competitiveness in the advanced economies remain to be implemented. The larger the scale of the quantitative easing environment and the longer the exceptionally low interest rate lasts, the greater will be the uncertainty and risks of the eventual exit. Therefore, we must remain vigilant to developments in the global financial and economic systems and at the same time guard against and, more importantly, stand ready to cope with possible shocks that may hit Hong Kong in the months ahead.

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.

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.

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 2012 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 2012 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 2012 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 2012 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 2012.

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 2012 the Sub-Committee met once.

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, GBS, 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

Professor 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

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

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

Mr Carlson TONG, JP
Chairman
Securities and Futures Commission

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

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

Dr David WONG Yau-kar, BBS, JP
Managing Director
United Overseas Investments Limited

Advisory Committees

Dr LO Ka-shui, GBS, JP
Chairman and Managing Director
Great Eagle Holdings Limited
(from 1 February 2012)

Professor Stephen CHEUNG Yan-leung, BBS, JP
Dean, School of Business and Professor (Chair) of Finance
Hong Kong Baptist University
(from 1 September 2012)

Mrs Angelina LEE WONG Pui-ling, SBS, JP
Partner
Woo, Kwan, Lee & Lo
(from 1 September 2012)

Mr Philip TSAI Wing-chung, JP
Audit Partner
Deloitte Touche Tohmatsu
(from 1 September 2012)

Dr Patrick FUNG Yuk-bun, JP
Chairman and Chief Executive
Wing Hang Bank Limited
(until 2 October 2012)

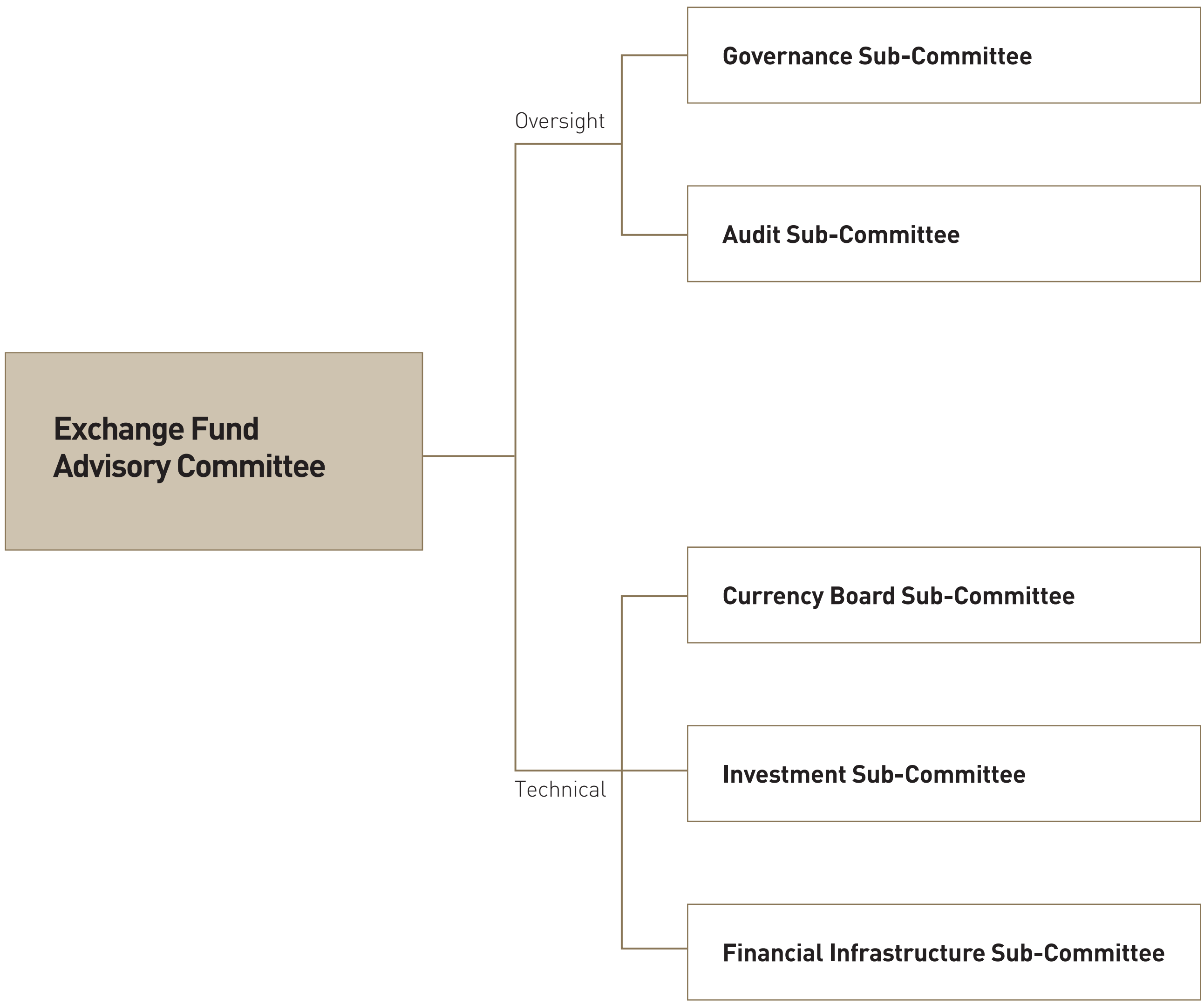
Professor CHAN Yuk-shee, SBS, JP
President
Lingnan University of Hong Kong
(until 31 August 2012)

Mr David SUN Tak-kei, BBS, JP
(until 29 June 2012)

Secretary

Mr Alan AU

THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

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

Members

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

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

Dr David WONG Yau-kar, BBS, JP
Managing Director
United Overseas Investments Limited

Professor Stephen CHEUNG Yan-leung, BBS, JP
Dean, School of Business and Professor (Chair) of Finance
Hong Kong Baptist University
(from 1 September 2012)

Mr Philip TSAI Wing-chung, JP
Audit Partner
Deloitte Touche Tohmatsu
(from 1 September 2012)

Mr David SUN Tak-kei, BBS, JP
(until 29 June 2012)

Dr John CHAN Cho-chak, GBS, JP

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

Mr Carlson TONG, JP
Chairman
Securities and Futures Commission

Dr LO Ka-shui, GBS, JP
Chairman and Managing Director
Great Eagle Holdings Limited
(from 1 February 2012)

Mrs Angelina LEE WONG Pui-ling, SBS, JP
Partner
Woo, Kwan, Lee & Lo
(from 1 September 2012)

Professor CHAN Yuk-shee, SBS, JP
President
Lingnan University of Hong Kong
(until 31 August 2012)

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.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE AUDIT SUB-COMMITTEE

Chairman

Mr Carlson TONG, JP
Chairman
Securities and Futures Commission
(from 1 July 2012)

Mr David SUN Tak-kei, BBS, JP
(until 29 June 2012)

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 Philip TSAI Wing-chung, JP
Audit Partner
Deloitte Touche Tohmatsu
(from 1 September 2012)

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.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE CURRENCY BOARD SUB-COMMITTEE

Chairman

Mr Norman T.L. CHAN, GBS, 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 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

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

Ms Anita FUNG Yuen-mei
Chairperson
The Hong Kong Association of Banks

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

Dr John GREENWOOD
Group Chief Economist
INVESCO Asset Management Limited

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, BBS, JP
Managing Director
United Overseas Investments Limited

Professor TSANG Shu-ki
Senior Research Fellow
Institute for Enterprise Development
School of Business
Hong Kong Baptist University
(until 12 November 2012)

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.

THE EXCHANGE FUND ADVISORY COMMITTEE INVESTMENT SUB-COMMITTEE

Chairman

Mr Norman T.L. CHAN, GBS, 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

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

Dr LO Ka-shui, GBS, JP
Chairman and Managing Director
Great Eagle Holdings Limited
(from 13 June 2012)

Professor CHAN Yuk-shee, SBS, JP
President
Lingnan University of Hong Kong
(until 31 August 2012)

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

Dr John CHAN Cho-chak, GBS, JP

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

Mr Carlson TONG, JP
Chairman
Securities and Futures Commission

Mrs Angelina LEE WONG Pui-ling, SBS, JP
Partner
Woo, Kwan, Lee & Lo
(from 1 September 2012)

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.

Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE FINANCIAL INFRASTRUCTURE SUB-COMMITTEE

Chairman

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

Members

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

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

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

Mr Lawrence LAM Yuk-kun
Senior Advisor, Greater China
National Australia Bank

Mr TSE Kam-keung
Senior Advisor — Asia Pacific
State Street Bank and Trust Company

Dr Patrick FUNG Yuk-bun, JP
Chairman and Chief Executive
Wing Hang Bank Limited
(until 2 October 2012)

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

Ms Anita FUNG Yuen-mei
Group General Manager
Chief Executive Officer Hong Kong
The Hongkong and Shanghai Banking Corporation Limited

Mr LAU Ming-wai, JP
Vice Chairman
Chinese Estates Holdings Limited

Professor Stephen CHEUNG Yan-leung, BBS, JP
Dean, School of Business and Professor (Chair) of Finance
Hong Kong Baptist University
(from 1 September 2012)

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, GBS, JP
The Monetary Authority

Members

Professor the Honourable K C CHAN, GBS, 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

Mr Carlson TONG, JP
Chairman
Securities and Futures Commission
Representing Securities and Futures Commission
(from 20 October 2012)

The Honourable NG Leung-sing, SBS, JP
Member
Legislative Council
(from 1 December 2012)

Mr Weber LO Wai-pak
Country Officer and Chief Executive Officer
Hong Kong and Macau
Citibank, N.A.

Dr the Honourable David LI Kwok-po, LLD, GBM, GBS, JP
Chairman and Chief Executive
The Bank of East Asia Limited
(until 30 November 2012)

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

Mr Eddy FONG Ching, GBS, JP
Chairman
Securities and Futures Commission
Representing Securities and Futures Commission
(until 19 October 2012)

Mrs Kathryn SHIH
CEO Wealth Management Asia Pacific
Group Managing Director
UBS AG

Mr Hidekazu HORIKOSHI
Executive Officer
Regional Head for Hong Kong and General Manager
The Bank of Tokyo-Mitsubishi UFJ, Limited
Hong Kong Branch
(from 1 December 2012)

Mr Hidemitsu OTSUKA
Executive Officer
Regional Head for Hong Kong and General Manager
The Bank of Tokyo-Mitsubishi UFJ, Limited
Hong Kong Branch
(until 22 June 2012)

Secretary

Ms Jasmin FUNG

THE DEPOSIT-TAKING COMPANIES ADVISORY COMMITTEE

Chairman

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

Ex Officio Member

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

Members

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

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

Ms Gilly WONG Fung-han
Chief Executive
Consumer Council
Representing the Consumer Council
(from 16 November 2012)

Ms Connie LAU Yin-hing, JP
Chief Executive
Consumer Council
Representing the Consumer Council
(until 15 November 2012)

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

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

Mr Frederick CHIN Voon-fat
Chief Executive
Banc of America Securities Asia Limited
(until 30 November 2012)

Secretary

Ms Jasmin FUNG

Chief Executive's Committee

Norman T.L. CHAN, GBS, 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)
(until 31 December 2012)

Chief Executive Officer
Hong Kong Mortgage Corporation
(from 1 January 2013)

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)

Vincent LEE
Director-General (Enforcement)
(from 1 January 2013)

James H LAU Jr, JP
Chief Executive Officer
Hong Kong Mortgage Corporation
(until 31 December 2012)

HKMA Organisation Chart

1 January 2013

- **Chief Executive** Norman T.L. CHAN
  - **Deputy Chief Executive** Arthur YUEN
    - **Executive Director (Banking Conduct)** Meena DATWANI
      - **Head (Deposit Protection Scheme)** Tess LEUNG
      - **Head (Payment Systems Oversight & Licensing)** Trevor KEEN
      - **Head (Banking Conduct) 1** Alice LEE
      - **Head (Banking Conduct) 2** Francis LAU
    - **Executive Director (Banking Policy)** Karen KEMP
      - **Head (Banking Policy) A** Rita YEUNG
      - **Head (Banking Policy) B** Richard CHU
    - **Executive Director (Banking Supervision)** Nelson MAN
      - **Head (Banking Supervision) 1** James TAM
      - **Head (Banking Supervision) 2** Lawrence CHEUNG
      - **Head (Banking Supervision) 3** Sunny YUNG
      - **Head (Banking Supervision) 4** Steve LAU
      - **Head (Banking Supervision) 5**
    - **Director-General (Enforcement)** Vincent LEE
      - **Head (Enforcement) 1** Angus CHAN
      - **Head (Enforcement) 2** Billy LAI
  - **General Counsel** Stefan GANNON
    - **Deputy General Counsel 1** Feliciana CHEUNG
    - **Deputy General Counsel 2** Joanna WONG
    - **Deputy General Counsel 3** Stephen LAW
  - **Administrative Assistant/CE** Raymond CHAN
  - **Head (Internal Audit)** Kim CHONG
  - **Deputy Chief Executive** Peter PANG
    - **Executive Director (Financial Infrastructure)** Esmond LEE
      - **Head (Financial Infrastructure Development)** LI Shu-pui
      - **Head (Payment Systems Operation)** Colin POU
    - **Executive Director (Monetary Management)** Edmond LAU
      - **Head (Currency)** Lydia CHAN
      - **Head (Financial Stability Surveillance)** Henry CHENG
      - **Head (Market Development)** Daryl HO
      - **Head (Monetary Operations)** Kitty LAI
    - **Executive Director (Research)** Dong HE
      - **Head (Economic Research)** Lillian CHEUNG
      - **Head (Market Research)** HUI Cho-hoi
  - **Head (Risk Management & Compliance)** Grace LAU
  - **Deputy Chief Executive** Eddie YUE
    - **Executive Director (External)** Carmen CHU
      - **Head (External) 1** Stephen WAN
      - **Head (External) 2** Gillian HUI
      - **Chief Representative (New York Representative Office)** Brian LEE
    - **Executive Director (Reserves Management)** Francis CHU
      - **Head (Direct Investment) 1** Edmund NG
      - **Head (Direct Investment) 2** HUH Yong-hak
      - **Head (External Managers)** Martin MATSUI
    - **Executive Director (Corporate Services)** Howard LEE
      - **Head (Administration)** Jennie WONG
      - **Head (Corporate Development)** Alan AU
      - **Head (Finance)** Thomas YIP
      - **Head (Information Technology)** TAN Yong-wah

Economic and Financial Environment

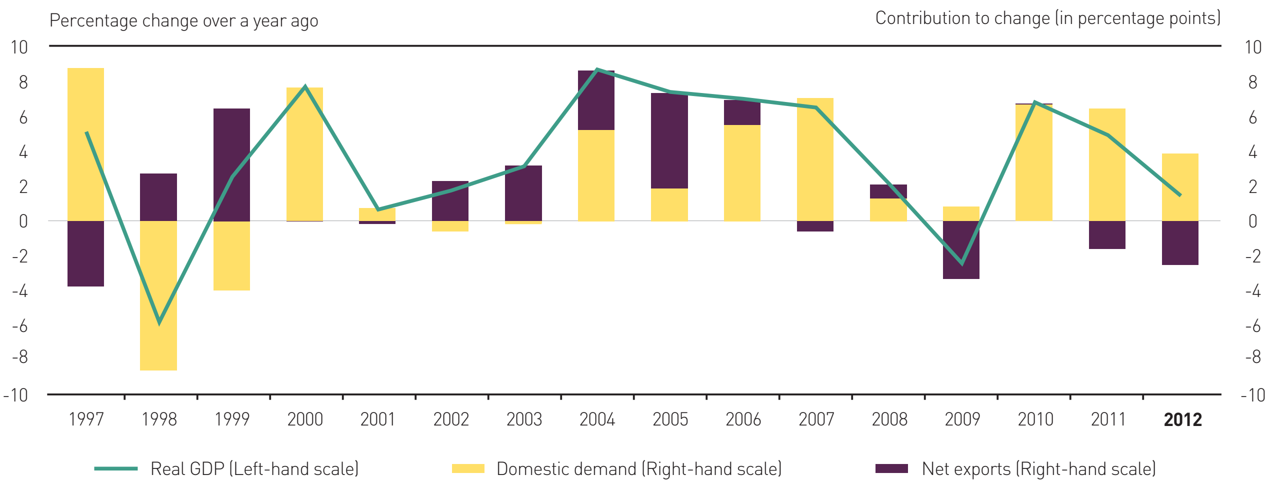
The Hong Kong economy continued to face strong external headwinds, showing only modest growth in 2012. Economic activity is expected to pick up gradually in 2013, but risks to consumer and asset prices remain amid loose global monetary conditions.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy advanced at a tepid pace during the year amid external pressures stemming from the lingering European sovereign debt problems and fragile growth in the US (Chart 1). Domestic demand, on the other hand, remained resilient on the strength of a tight labour market and rising income, robust capital spending and supportive fiscal policy. For 2012, real GDP growth slowed visibly to 1.4% from 4.9% in 2011 (Table 1). Consumer price pressures receded in line with the slowing economy. The stock market fluctuated in the first half, but shored up later in the year with increased investor demand amid fund inflows. The property market turned buoyant again after some consolidation in the second half of 2011, prompting the HKMA and the Administration to introduce fresh rounds of measures to address the increasing risk of overheating.

Chart 1 **Real GDP growth by contribution**



Source: Census and Statistics Department.

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

(% Period-over-period, unless otherwise specified)	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2012	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2011
Gross Domestic Product	**0.4**	**-0.1**	**0.8**	**1.2**	**1.4**	2.7	-0.4	0.2	0.5	4.9
(year-on-year growth)	**0.8**	**1.0**	**1.4**	**2.5**		7.6	5.1	4.0	3.0	
Private consumption expenditure	**1.3**	**0.0**	**1.3**	**1.5**	**4.0**	1.7	3.0	1.3	0.3	9.0
Government consumption expenditure	**1.3**	**0.9**	**0.8**	**0.7**	**3.7**	1.2	0.1	0.9	1.0	2.5
Exports										
Exports of goods	**0.9**	**-1.7**	**3.0**	**4.8**	**1.3**	8.4	-7.4	0.2	1.1	3.4
Exports of services	**0.3**	**1.1**	**-2.1**	**2.1**	**1.2**	1.2	1.1	0.5	0.1	4.9
Imports										
Imports of goods	**2.3**	**-0.9**	**1.5**	**5.2**	**2.7**	8.3	-4.2	-0.6	0.5	4.7
Imports of services	**0.6**	**-1.0**	**-1.2**	**1.2**	**0.7**	0.4	0.5	0.3	1.2	3.5
Overall trade balance (% of GDP)	**-0.6**	**-5.9**	**4.2**	**1.8**	**0.0**	4.9	-3.4	6.1	4.4	3.1

Source: Census and Statistics Department.

Economic and Financial Environment

Monetary conditions remained loose in Hong Kong in 2012. The Hong Kong dollar interbank interest rates still hovered at low levels, while banks' funding costs edged down slightly. In the fourth quarter, the strong-side Convertibility Undertaking was triggered alongside inflows of funds, resulting in a sharp expansion in the Aggregate Balance and the Hong Kong dollar Monetary Base. On the credit side, after two years of rapid growth, bank lending increased at a much slower pace of 9.6% in 2012. If only Hong Kong dollar loans for domestic use were considered, there was just a mild 4.6% growth, which was slower than Hong Kong's nominal GDP growth of 5.4% during the year.

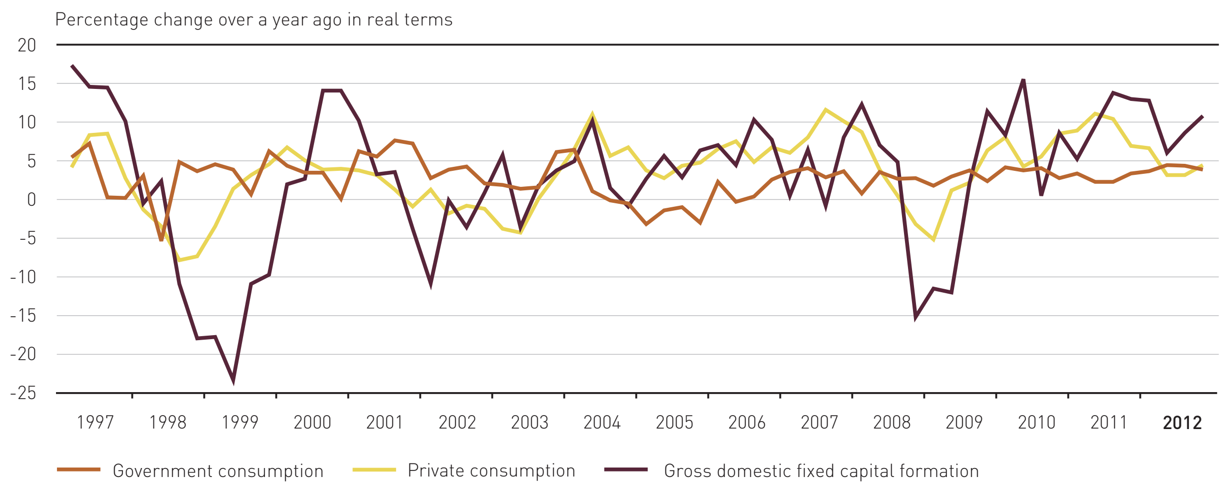
Domestic demand

Domestic demand remained resilient against the external headwinds. Private consumption grew further by 4.0% on the back of stable job and income conditions, greater housing wealth and the fiscal stimulus (Chart 2). Government consumption growth also held up well at 3.7%. While business sentiment was generally cautious, overall fixed capital formation expanded appreciably by 9.1%, buoyed by robust public and private construction activity and increased capital spending on machinery and equipment. Inventory investment, however, remained a drag on output growth.

External demand

External demand for Hong Kong's exports remained weak in general, although signs of improvement were emerging in the second half of the year. Drags continued to come mainly from the still-unresolved European sovereign debt problems and protracted sluggish growth in the US, which also weighed on the activities of Hong Kong's other trading partners. As a result, Hong Kong's merchandise exports struggled, and just managed to increase mildly in 2012, while exports of services grew by a meagre 1.2% (Chart 3). Imports of goods and services still fared relatively well as domestic demand remained firm. Taken together, net exports dragged down output growth by 2.5 percentage points during the year. In nominal terms, the overall trade balance was in surplus, amounting to $0.8 billion (0.04% of GDP), compared with the $60.0 billion surplus (3.10% of GDP) in 2011.

Chart 2 Domestic demand

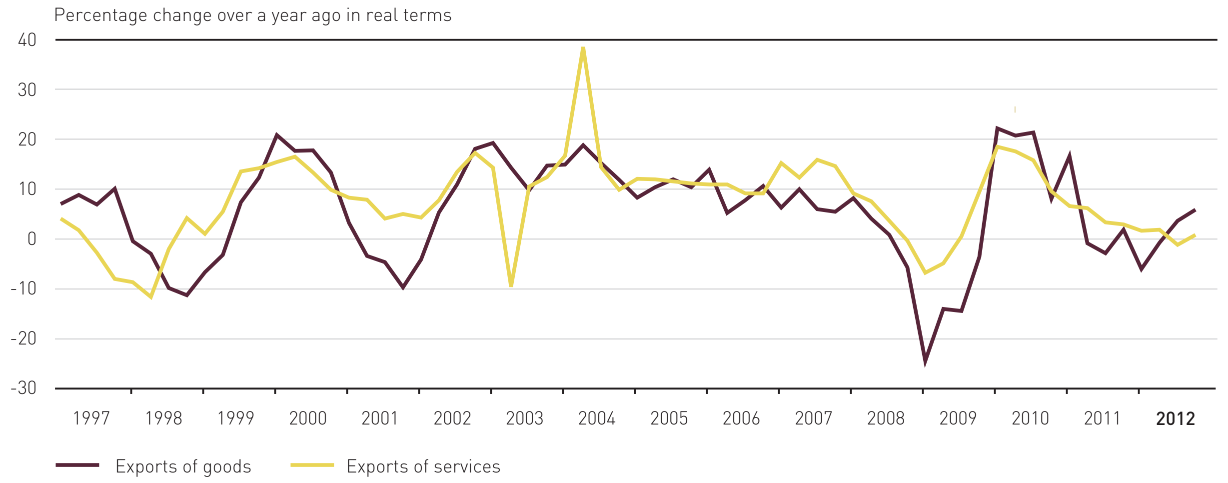


Source: Census and Statistics Department.

Inflation

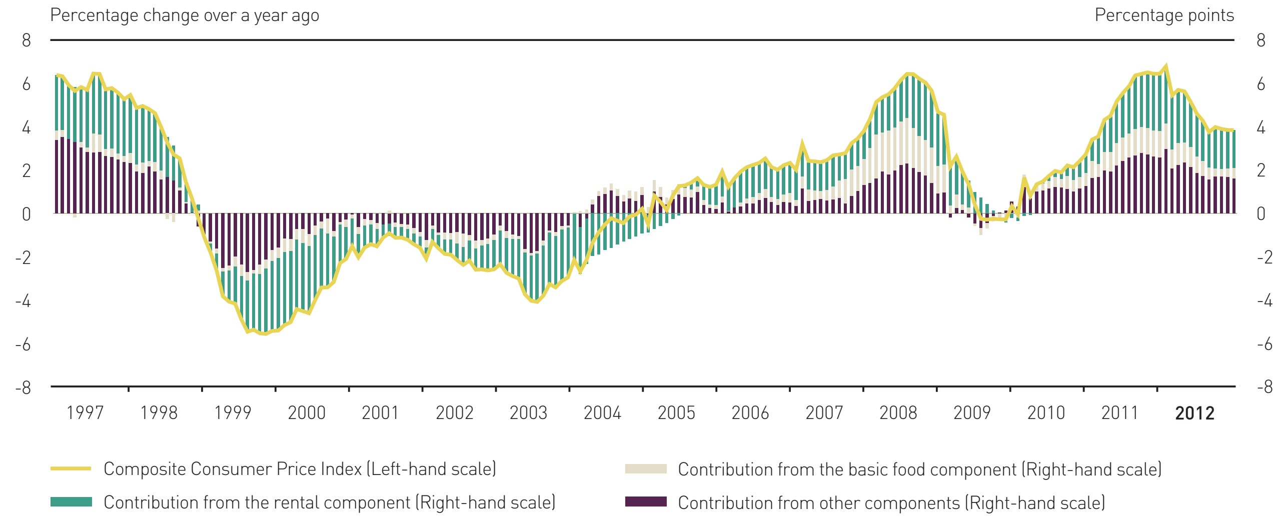
There was some relief in consumer price pressures in 2012, with the headline inflation rate receding to 4.1% from 5.3% a year ago. Netting out the effects of the Government's one-off relief measures, the underlying inflation rate weakened to 4.7%, with all major components showing some moderation (Chart 4). In particular, food inflation tapered off alongside a stabilisation in global food prices, while the pass-through of rising residential rentals slowed during most of 2012. Upward pressures on wages and non-tradable costs also softened. However, consumer price pressures appeared to have increased towards the end of the year as the economy improved gradually and residential rentals for fresh leases surged again.

Chart 3 Exports of goods and services



Source: Census and Statistics Department.

Chart 4 Consumer price inflation



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

Source: Census and Statistics Department.

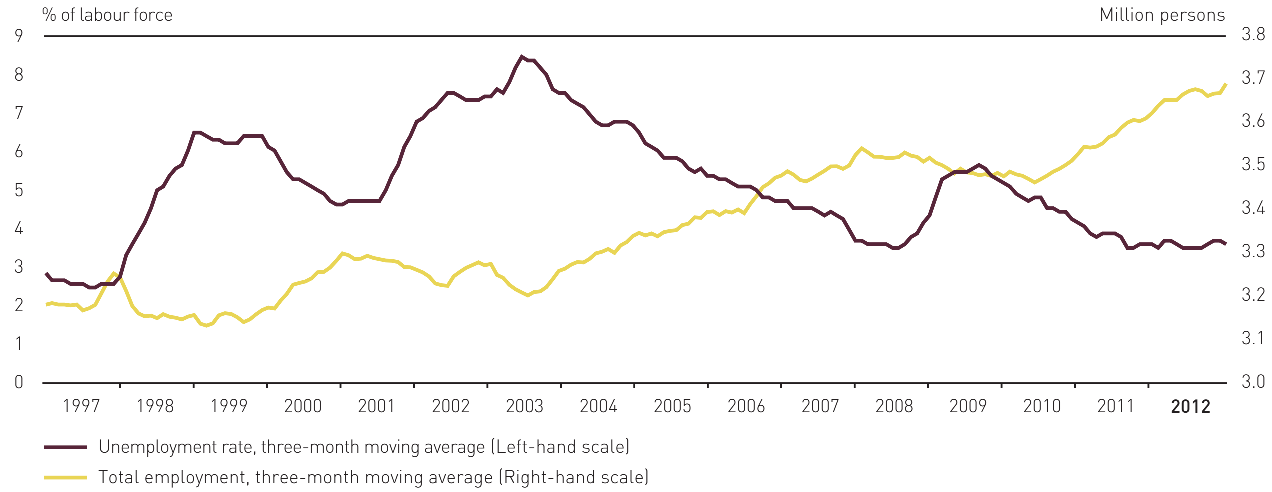
Labour market

The labour market remained tight in spite of a slowing economy influenced by the adverse external factors. Labour demand on the whole strengthened steadily, especially in the domestic-oriented and tourism-related sectors. For the year, total employment increased by 2.4% to a record high and the unemployment rate edged down to a 15-year low of 3.3% (Chart 5). Together with the tight labour market, wages and earnings rose solidly across major sectors and occupation categories. On average, employment earnings for full-time workers rose by 6.5% in nominal terms and 2.3% in real terms in 2012.

Stock market

The Hong Kong stock market experienced some volatility during the year. After a short rebound in the first two months, local stock prices were weighed down during most of the second quarter by concerns about the European sovereign debt problems and weakness in global growth. Stock prices then recovered previous losses as financial market conditions gradually improved in the second half of the year. Tail risks in Europe were perceived to have diminished after the European Central Bank's announcement of the Outright Monetary Transactions programme, while additional quantitative easing in the US also provided support for investment into riskier assets.

Chart 5 **Labour market conditions**



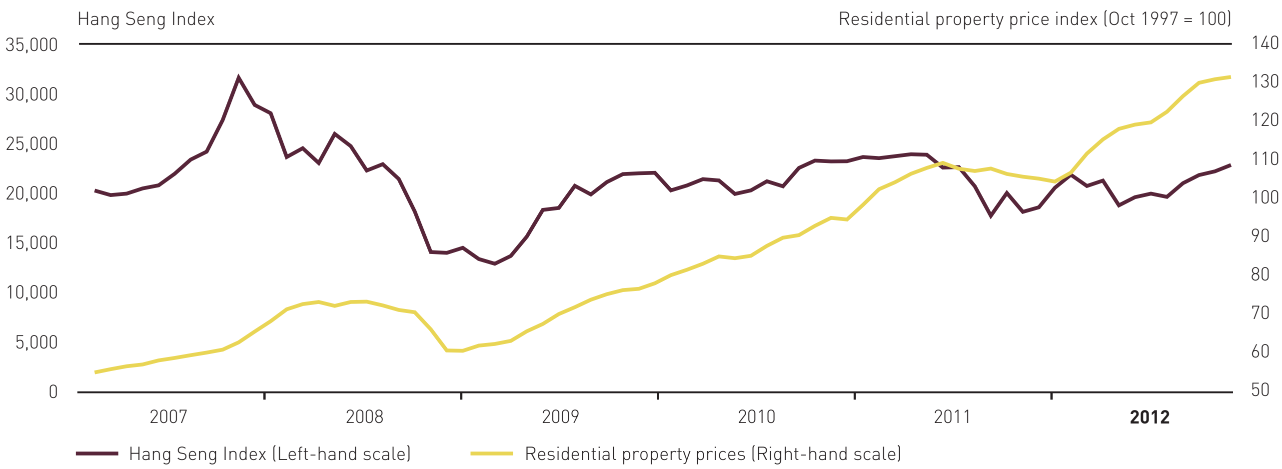
Source: Census and Statistics Department.

Overall, the Hang Seng Index surged by 22.9% to close the year at 22,657 (Chart 6). The average daily turnover of the stock market, however, contracted by 22.7% to $53.7 billion. Meanwhile, equity capital raised through new share flotation and post-listing arrangements on the local stock market declined by 37.7% to $305.4 billion.

Property market

After a brief respite in the second half of 2011, the rise in property prices resumed and trading activities grew again in 2012. Flat prices on average increased by 25.2% and have more than doubled from the trough of 2008, while housing affordability deteriorated further. Indicators, such as the price-to-income ratio and the mortgage payment-to-income ratio, all rose to recent highs and well above their 10-year long-term average levels. To strengthen banks' resilience against a major drop in property prices, the HKMA introduced a new round of prudential measures in mid-September to strengthen banks' risk management in property lending business, by tightening the underwriting criteria for loans to borrowers with multiple property mortgages and imposing a 30-year ceiling for mortgage tenors. The Administration also introduced a series of demand-side and supply-side measures to promote a healthy and stable development of the housing market. Following these measures, flat prices and transaction activity moderated somewhat.

Chart 6 Asset prices



Sources: Rating and Valuation Department, and CEIC.

OUTLOOK FOR THE ECONOMY

Economic environment

The Hong Kong economy is expected to grow faster in 2013. The drags from external demand should subside gradually, although a full recovery in Hong Kong's exports still takes time as the global economy is struggling to achieve sustained growth, particularly in Europe, which remains burdened with sovereign debt problems. Domestically, consumer spending should continue to lend support to growth in real activity, owing to the strength of the labour market, rising incomes over the past few years and the positive wealth effect. Large-scale infrastructure works and private building activity are also expected to hold up quite well, but the outlook for capital investment and inventory stocking is less certain given that business sentiments remain cautious. Overall for 2013, the Government sees real GDP growth in the range of 1.5 – 3.5% and private sector analysts project the economy to grow by 2.5 – 4.7%, averaging at around 3.5%.

Inflation and the labour market

Inflationary pressures are likely to remain steady in 2013, largely reflecting a closing local output gap and soft global commodity prices. In the near term, however, the renewed pick up in residential rentals will pose upward pressure on inflation. Private sector analysts now expect the headline inflation rate will be at 4.2% in 2013. Labour market conditions will likely continue to be broadly favourable with hiring intentions staying positive, according to a number of corporate surveys. For the full year, private sector analysts project the unemployment rate to stay low at 3.4% on average.

Uncertainties and risks

The outlook for 2013 is subject to a number of uncertainties and risks. First and foremost, the unresolved European sovereign debt problems and the uncertain US fiscal outlook will continue to cast a shadow over Hong Kong's growth prospects. Any significant adverse developments could have negative spillover effects on the Hong Kong economy through trade and financial channels. On the other hand, there are potential upside risks to growth from a faster-than-expected stabilisation in external conditions, particularly a speed up in the Mainland economy.

More aggressive monetary easing in advanced economies will further increase global liquidity. This has already resulted in renewed capital inflows into Hong Kong. If capital inflows were to continue this, together with the very loose monetary conditions presently facing Hong Kong, could exert further upward pressures on consumer and asset prices and fuel a fresh round of rapid growth in bank credit. In addition, another rise in housing prices could further aggravate misalignments in Hong Kong's economic fundamentals, which would result in many macro-financial risks for Hong Kong. For example, the mortgage burden remains masked by the current ultra-low interest rate environment and, given the limited room for interest rates to decline, borrowers could face interest rate risks. On the credit front, total loan growth could rebound due in part to a larger Aggregate Balance and improving liquidity.

The uncertain direction and size of fund flows could also be a source of volatility. The experience over the past few years shows that fund flows can be highly sensitive to global financial conditions and investors' risk appetite. The risk of a sudden unwinding could cause considerable volatility to financial market conditions, as well as stress to the domestic banking and financial system.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained robust in 2012, despite the heightened uncertainties in the global economic outlook and external environment. Credit growth moderated during the year and liquidity conditions improved. Asset quality remained sound and locally incorporated authorized institutions (AIs) continued to be well capitalised.

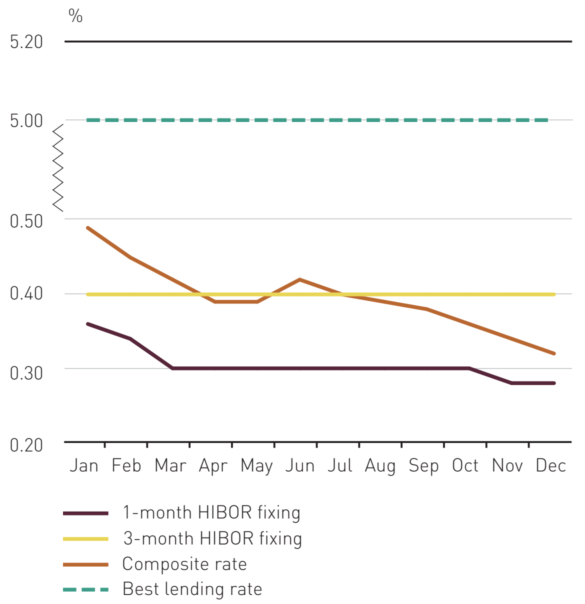
Interest rate trends

Central banks in major developed economies continued to adopt accommodative monetary policies in 2012, with some introducing further easing measures. In line with the US dollar rates, Hong Kong dollar interbank interest rates remained low throughout the year. The composite interest rate, which reflects the average cost of funds of retail banks, also trended lower as liquidity conditions improved during the year (Chart 7).

Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 12.7%, mainly due to a 14.5% increase in net interest income. As their balance sheets grew at a slower pace, the post-tax return on average assets of retail banks increased to 1.07% in 2012 from 1.02% in 2011 (Chart 8).

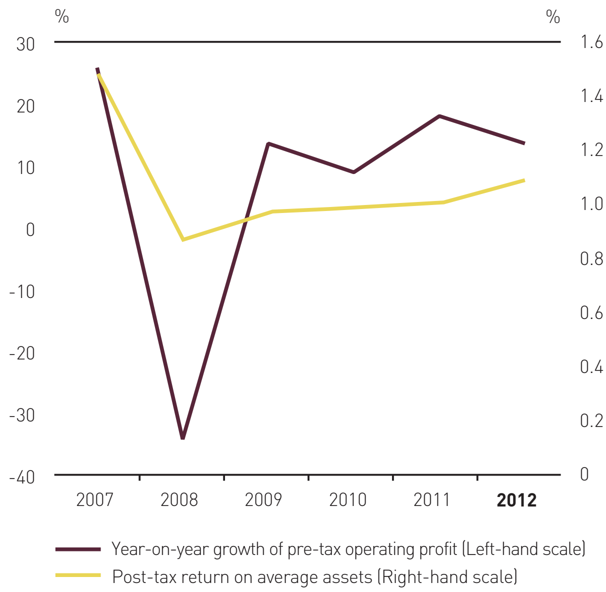
Chart 7 **HIBOR fixings, composite rate and best lending rate**



Notes:

1. HIBOR fixings refer to the Hong Kong dollar Interest Settlement Rates released by the Hong Kong Association of Banks and are monthly averages.
2. Best lending rate refers to the rate quoted by the Hongkong and Shanghai Banking Corporation Limited (monthly averages).

Chart 8 **Retail banks' performance**



With the improved liquidity conditions and lower funding costs, the net interest margin of retail banks widened slightly to a yearly average of 1.36% compared with 1.24% in 2011 (Chart 9).

The growth in net interest income (+14.5%) of retail banks outpaced that of non-interest income (+6.5%) in 2012. Apart from the widened net interest margin, moderate credit expansion also contributed to the growth in net interest income. As a result, retail banks' non-interest income as a share of total operating income fell to 46.1% from 47.9% in 2011.

The operating costs of retail banks increased by 8.2%, partly due to rising staff and rental expenses. Nonetheless, the cost-to-income ratio was down for the second consecutive year to 45.6% from 46.6% in 2011 driven by the stronger growth in operating income during the period (Chart 10).

The net charge for debt provisions rose slightly to $3.2 billion from $2.8 billion in 2011.

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

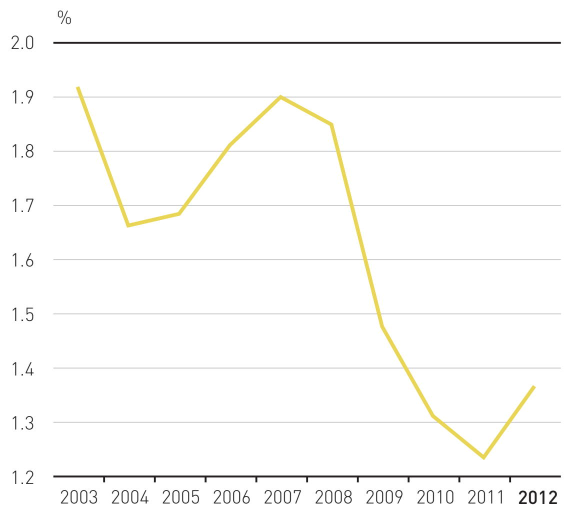
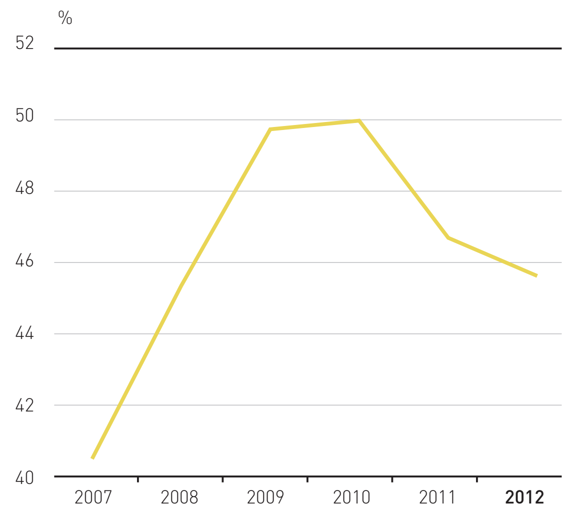


Chart 10 **Retail banks' cost-to-income ratio**



Asset quality

The asset quality of retail banks remained sound in 2012. Notwithstanding the overall loan expansion, the aggregate amount of classified loans declined during the year. As a result, the classified loan ratio continued its downward trend and reached 0.47% at the end of 2012 from 0.59% at the end of 2011. The combined ratio of overdue and rescheduled loans also reduced to 0.37% compared with 0.49% a year earlier (Chart 11).

The quality of surveyed institutions' residential mortgage lending remained good. The delinquency ratio rose slightly to 0.02% at the end of 2012 from 0.01% a year earlier (Chart 12). The rescheduled loan ratio edged down to 0.01% from 0.02% in 2011. With higher residential property prices, the surveyed institutions did not report any residential mortgage loans in negative equity at the end of the year, compared with 1,465 cases at the end of 2011.

The quality of credit card portfolios deteriorated slightly. The delinquency ratio rose to 0.20% at the end of 2012 from 0.19% in 2011 (Chart 12). The combined delinquent and rescheduled ratio edged up to 0.26% from 0.25% last year and the charge-off ratio rose to 1.70% from 1.49% in 2011. Despite the increases, these ratios were still low by historical standards.

Chart 11 **Asset quality of retail banks**

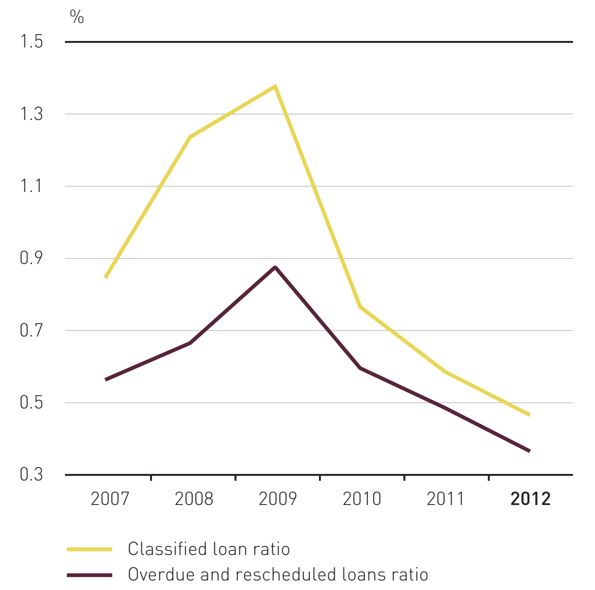
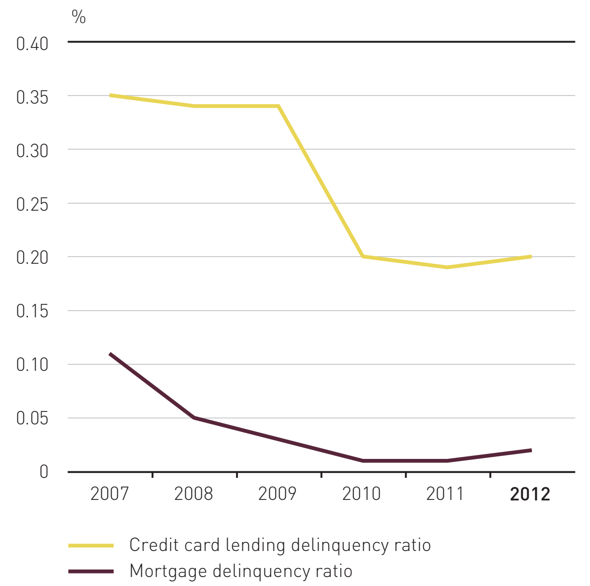


Chart 12 **Delinquency ratios of residential mortgages and credit card lending of surveyed institutions**



Balance sheet trends

Total loans and advances of retail banks grew by 8.4% in 2012, while total deposits rose by 9.3%. The overall loan-to-deposit ratio of retail banks, therefore, decreased to 54.8% from 55.3% in 2011. The Hong Kong dollar loan-to-deposit ratio also fell to 72.3% from 76.2% a year ago (Chart 13).

Credit growth moderated from 20.2% in 2011 to 9.6% in 2012. The growth in loans for use outside Hong Kong continued to outpace that in loans for use in Hong Kong and trade financing. The increase in domestic lending was mainly led by property lending and lending to wholesale and retail sectors.

Retail banks' total non-bank Mainland exposures[1] rose to $1,777 billion at the end of 2012 from $1,572 billion a year ago. For the banking sector as a whole, non-bank Mainland exposures increased to $2,738 billion from $2,330 billion in 2011.

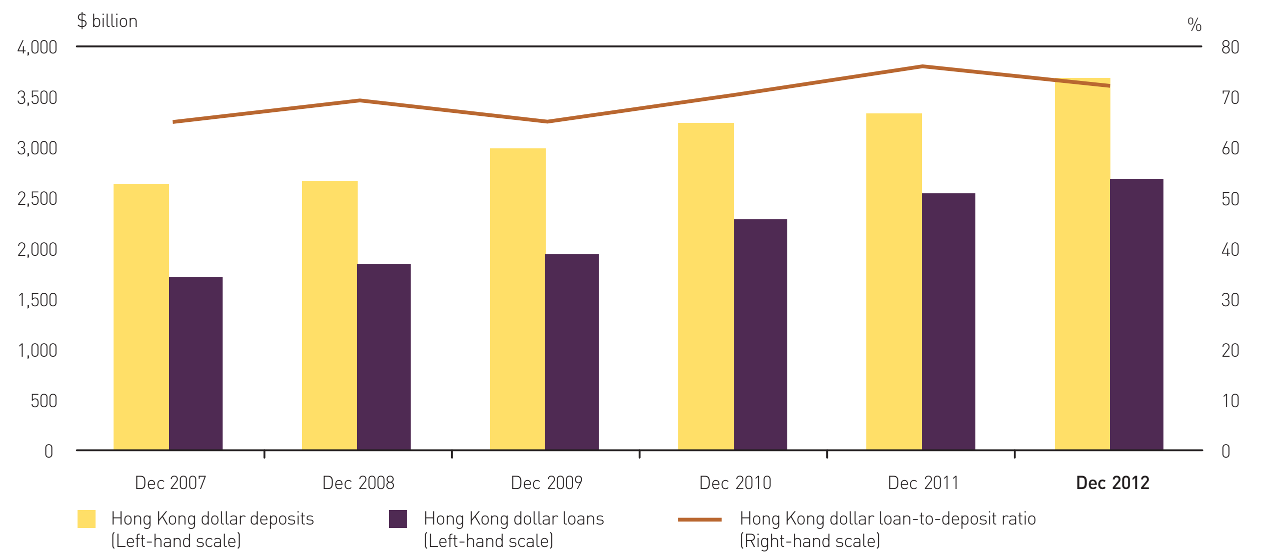
Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, increased by 10.0% in 2012. Despite the increase, the share of total holdings of NDIs relative to total assets remained unchanged at 24% at the end of 2012. Among the holdings of NDIs, 49% were government-issued (47% in 2011), 29% were issued by non-bank corporates (31% in 2011), and 22% were issued by banks (22% in 2011) (Chart 14).

Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. The consolidated capital adequacy ratio of all locally incorporated AIs edged down to 15.7% at the end of 2012 from 15.8% a year earlier (Chart 15). However, the Tier-1 capital adequacy ratio climbed to 13.3% at the end of 2012 from 12.4% a year earlier.

Chart 13 **Retail banks' Hong Kong dollar loans and deposits**



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

Underpinned by a stronger increase in liquefiable assets than in qualifying liabilities, the average liquidity ratio of retail banks rose to 42.6% in the final quarter of 2012 from 38.0% in the same quarter last year, which is well above the statutory minimum of 25% (Chart 16).

Chart 14 **Retail banks' holdings of negotiable debt instruments at the end of 2012 (counterparty breakdown)**

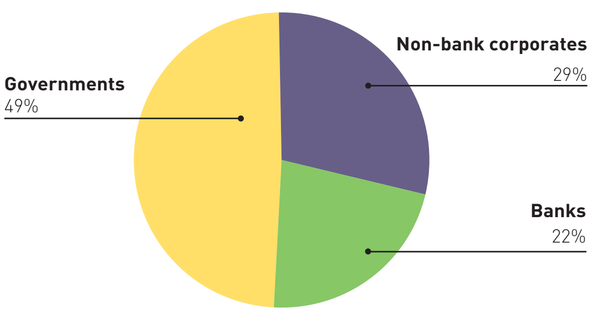


Chart 15 **Consolidated capital adequacy ratio of locally incorporated AIs**

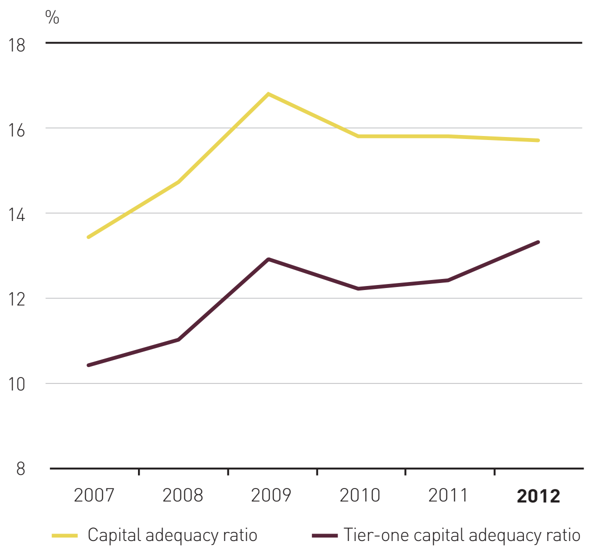
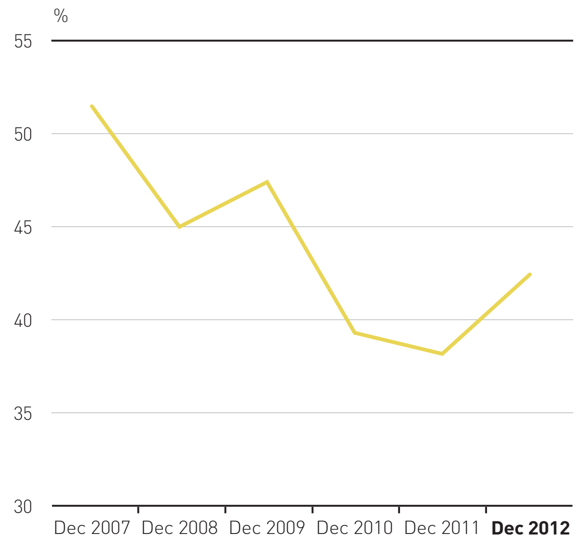


Chart 16 **Retail banks' liquidity ratio (quarterly average)**



PROSPECTS FOR 2013

While the persistently low interest rates in advanced economies are likely to remain in place for some time, the risk arising from the increased uncertainties in the global economic outlook and external environment has yet to recede. This, in turn, could translate into significant systemic risk for the Hong Kong banking sector. Therefore, banks must continue to be vigilant against a possible deterioration in macroeconomic conditions and the risk of a sudden outflow of funds or sharp changes in interest rate trends. Although credit growth in the banking sector moderated in the past year and asset quality remained sound, banks should continue to exercise prudence in managing their credit, liquidity and other risks.

Monetary Stability

Despite a volatile external environment, the Hong Kong dollar exchange rate traded within a very narrow range against the US dollar throughout 2012. The Linked Exchange Rate system (LERS) remained a cornerstone of Hong Kong's monetary and financial stability, and the money market continued to function smoothly with ample interbank liquidity.

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 Hong Kong dollars 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 Hong Kong dollars 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 2012**	31 December 2011
Certificates of Indebtedness[1]	**291,675**	259,815
Government-issued currency notes and coins in circulation[1]	**9,997**	9,930
Balance of the banking system	**255,851**	148,684
Exchange Fund Bills and Notes (EFBN) issued[2]	**661,396**	658,748
Total	**1,218,919**	1,077,177

[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. The EFBN issued on tender dates but not yet settled are included in the balance sheet but excluded from the Monetary Base.

Monetary Stability

REVIEW OF 2012

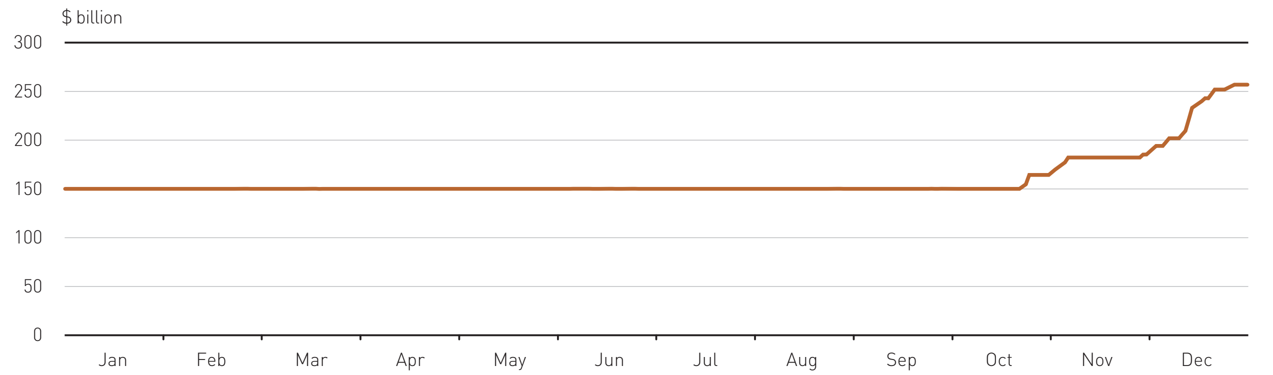
Exchange-rate stability

The Hong Kong dollar exchange rate remained within a very narrow range against the US dollar (Chart 1). In the first half of the year, the Hong Kong dollar exchange rate strengthened gradually from around 7.770 to 7.755 against the US dollar, although with occasional fluctuations amid the uncertainties surrounding the global economic and financial environment, particularly the ongoing European sovereign debt problems. In July and August, the Hong Kong dollar exchange rate was broadly stable. However, strengthening pressure again gathered pace, moving the Hong Kong dollar exchange rate closer towards the strong-side CU of 7.75 for the rest of the year.

Between 19 October and 21 December, the strong-side CU was repeatedly triggered and the HKMA passively purchased a total of US$13.8 billion in response to banks' offers, creating HK$107.2 billion consistent with the Currency Board system. As a result, the Aggregate Balance increased to $255.9 billion on 31 December from $148.7 billion a year ago (Chart 2). The inflows partly reflected the increased allocation to Hong Kong dollar assets by investors outside Hong Kong, as well as the proceeds from the issuance of foreign currency bonds by Hong Kong firms in exchange for Hong Kong dollars. The stronger equity initial public offerings activities in late November and December to some extent also supported the inflows.

Chart 1 **Market exchange rate in 2012**

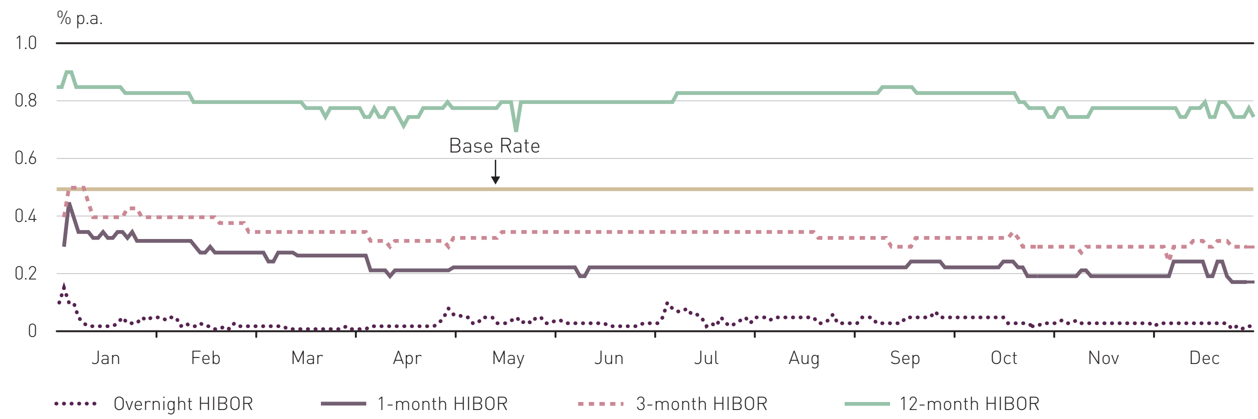
Chart 2 **Aggregate Balance in 2012**



Money market

Interbank liquidity improved steadily during the year. After temporary rises towards the end of 2011, the Hong Kong dollar interbank interest rates eased back in early 2012, tracking the downward movements in the US dollar interbank interest rates and partly due to a respite in the European sovereign debt problems (Chart 3). The interbank interest rates then held broadly stable, before ticking down again in the fourth quarter with the triggering of the strong-side CU and the corresponding rise in the Aggregate Balance. For the whole of 2012, short-dated interbank rates continued to stay much below the Base Rate of 0.5%. Discount Window borrowing was not active and amounted to only HK$3.0 billion. Overall, the money market and the forward market continued to operate orderly and smoothly.

Chart 3 Hong Kong dollar interbank interest rates and the Base Rate in 2012



The Linked Exchange Rate system

Against the backdrop of additional quantitative easing in the US and the triggering of the strong-side CU, there was renewed discussion among commentators about the soundness of the LERS. The Hong Kong Special Administrative Region Government reiterated its full commitment to the LERS, and the HKMA also explained to the public that when the strong-side CU is triggered by capital inflows, its ability to create Hong Kong dollars is unlimited under the Currency Board system. Stability in the foreign exchange and money markets suggests the public has strong confidence in the Government's commitment. In its annual Article IV Consultation with Hong Kong, the International Monetary Fund (IMF) strongly endorsed the LERS as a simple, credible, transparent and widely understood exchange rate system which has contributed immensely to the maintenance of monetary and financial stability in Hong Kong.

A sound banking system is a crucial condition for the normal functioning of the LERS. During the year, the HKMA continued to closely monitor banks' exposure to the property market and stepped up its supervisory efforts on mortgage lending. In September, after the announcement of additional quantitative easing in the US, the HKMA introduced a new round of prudential measures to further strengthen banks' risk management in property mortgage lending business, including tightened underwriting criteria for loans to borrowers with multiple property mortgages and a newly introduced ceiling for loan tenors. The HKMA also reminded the public to manage carefully the risk of higher interest rates.

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 within a tight range of 108 – 109% during 2012, without touching the Upper or Lower Trigger Level. The ratio closed at 108.1% 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 Fund is a powerful buttress protecting Hong Kong's monetary and financial stability in the event of a crisis.

Chart 4 **Daily movement of the Backing Ratio in 2012**

Other activities

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2012, the Sub-Committee considered issues including the impact of Mainland China on Hong Kong's monetary conditions through the credit channels, the usefulness of non-core liabilities as a financial stability surveillance indicator, the safe-havenness[1] of the Hong Kong dollar and various currencies in relation to the US dollar, and the underlying causes for the change in Hong Kong's current account balance. Records of the Sub-Committee's discussions on these issues and the reports on Currency Board operations submitted to the Sub-Committee were published on the HKMA website.

The Hong Kong Institute for Monetary Research (HKIMR) continued to sponsor research in the fields of monetary policy, banking and finance. In 2012, it hosted 20 research fellows, published 32 working papers and one occasional paper.

The Institute also organised seven international conferences and workshops. The main ones included:

- The Third Annual International Conference on the Chinese Economy held in January with the theme "China's Macroeconomic Performance in the Medium-Term: Deepening Reforms and Further Opening Up". The conference covered a wide range of issues, such as China's external imbalances, labour incomes, productivity growth, monetary policies and interest rates, informal financing, and exchange rate policies

- The Fourth Financial Stability Conference of the International Journal of Central Banking held in May on Financial Crises: Causes, Consequences and Policy Options, which dealt with topics including the impact of unconventional monetary policy, the roles of credit supply, demand shocks on business cycles and financial crises, and capital and macroprudential regulation

- The Fifth Expert Forum on Advanced Stress Testing Techniques held in October, which was jointly organised by the Institute and the Monetary and Capital Markets Department of the IMF. The Forum brought together experts and practitioners from various central banks and international organisations who shared their knowledge and experience on best practices for banking system stress testing

- The BRICS[2] & Asia, Currency Internationalisation, and International Monetary Reform conference held in December, which was co-organised with The Centre for International Governance Innovation and the Asian Development Bank. The conference examined a range of issues on the fundamental systemic problems pushing economies to seek international monetary reforms, and presented views from the BRICS and Asian economies on currency internationalization and international monetary reform.

The Institute organised the tenth annual summer workshop, which discussed financial regulation, the dynamics of renminbi forward exchange rate markets, an optimal monetary policy under financial sector risk, the perils of quantitative easing, and eurodollar banking and currency internationalisation. It also held the tenth HKIMR conference on Mainland China's economy with the theme "Chinese Firms and Capital Going Global: Opportunities and Challenges". The conferences and workshops were attended by participants from academia, the financial services industry and global central banks. In addition, 28 public seminars were organised during the year covering a broad range of economic and monetary issues.

[1] The term "safe-havenness" refers to the degree of a financial asset playing the role of a safe haven, or the extent to which a financial asset is regarded by investors as a safe haven.

[2] Brazil, Russia, India, China and South Africa.

Notes and coins

At the end of 2012, the total value of banknotes in circulation was $291.7 billion, an increase of 12.3% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to $9.8 billion, up 0.7% (Charts 8 and 9). The value of $10 notes issued by the Government in circulation (both paper and polymer notes) reached $3.5 billion, a decrease of 5.8% from 2011.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2012

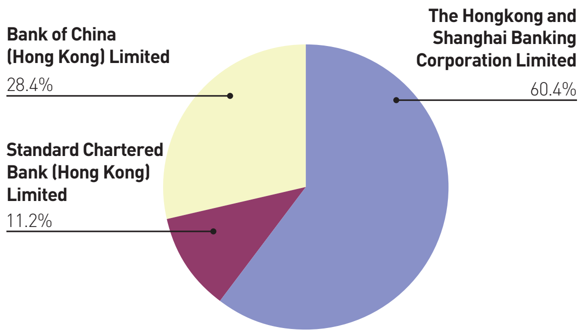
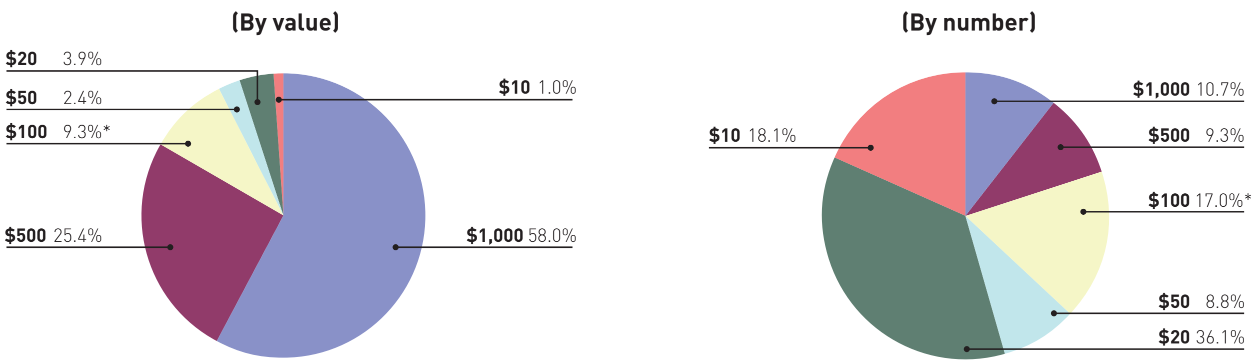


Chart 6 Distribution of banknotes in circulation at the end of 2012



* Includes 0.1 percentage point contributed by $150 banknotes.

Chart 7 **Banknotes in circulation at the end of 2012**

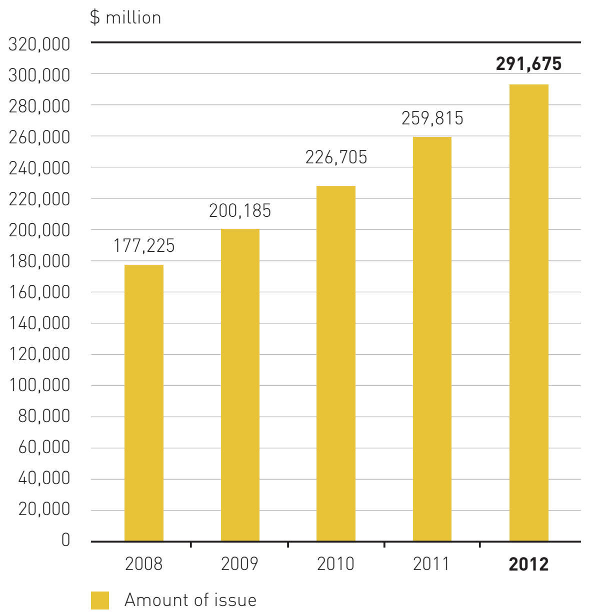


Chart 8 **Government-issued notes and coins in circulation at the end of 2012**

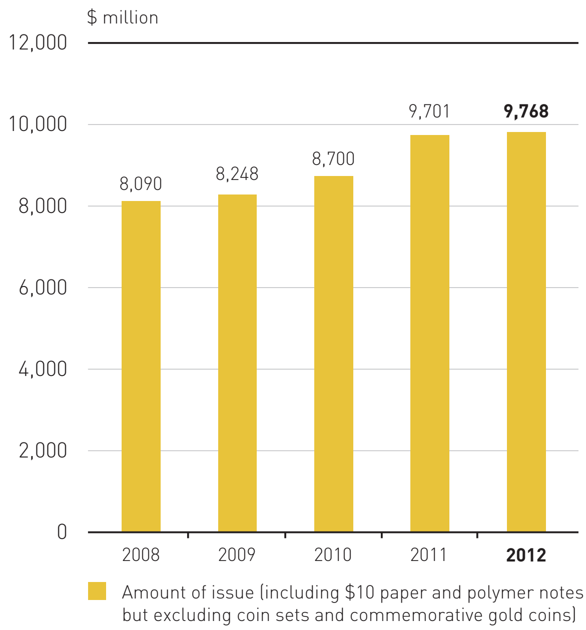
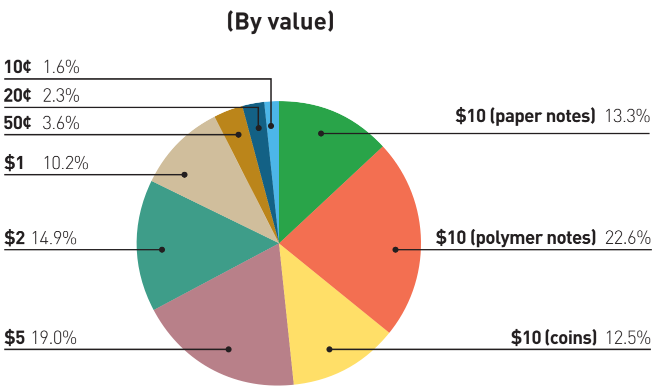
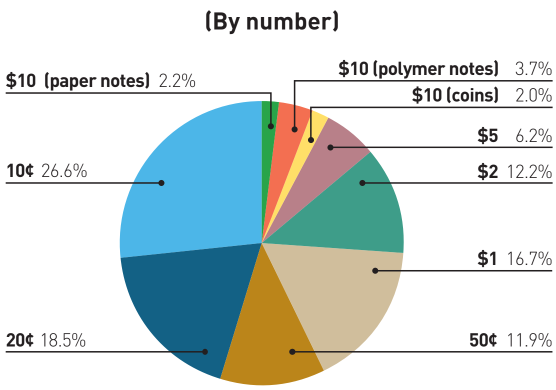


Chart 9 **Government-issued notes and coins in circulation at the end of 2012**





Hong Kong banknotes

All five denominations of the 2010 series banknotes have been in circulation since January 2012 and have been well received by the public. The security features are effective and easy to use, and the accessibility features are useful to the visually impaired in differentiating denominations. Public education programmes on the security features of Hong Kong Banknotes continue to be popular. During the year, 30 seminars were organised for over 5,000 participants, including bank tellers, retailers and students, to provide them with knowledge and skills for authenticating banknotes.

$10 polymer note

About 221 million polymer notes were in circulation at the end of 2012, representing 63% of the $10 notes issued by the Government.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with nine million coins removed from circulation in 2012.

Exchange Fund Bills and Notes

The HKMA streamlined the performance assessment framework for Market Makers under the Exchange Fund Bills and Notes (EFBN) Programme. The four quarterly reviews of Market Makers' performance each year were consolidated into two half-yearly exercises. The HKMA also adopted a more comprehensive approach in the selection of Eligible Market Makers, covering a broader range of quantitative and qualitative aspects of their performance, such as their activities in the primary and secondary markets of EFBN, and the quality of their market intelligence.

During the year, the HKMA continued to fine-tune the maturity mix of the EFBN with increased issuance of 10-year and 15-year Exchange Fund Notes. By the end of 2012, the amount of outstanding Exchange Fund paper stood at $657 billion (Table 2).

Table 2 Outstanding issues of Exchange Fund Bills and Notes

$ million	**2012**	2011
Exchange Fund Bills (by original maturity)		
28 days	**600**	600
91 days	**350,884**	348,313
182 days	**195,000**	195,000
364 days	**42,200**	42,200
Sub-total	**588,684**	586,113
Exchange Fund Notes (by remaining tenor)		
1 year or below	**17,000**	17,000
Over 1 year and up to 3 years	**25,900**	28,000
Over 3 years and up to 5 years	**11,200**	10,900
Over 5 years and up to 10 years	**8,600**	8,000
Over 10 years	**6,000**	5,400
Sub-total	**68,700**	69,300
Total	**657,384**	655,413

PLANS FOR 2013 AND BEYOND

The macro-financial environment is expected to remain challenging for Hong Kong in 2013. The European sovereign debt problems are not fully resolved and this will weigh on the region's growth prospects. In the US, political wrangling will continue to pose fiscal uncertainties in the near term. For Hong Kong, aggressive monetary easing in advanced economies and the loose monetary conditions could exert upward pressure on consumer and asset prices. In addition, fund flows and financial markets could be exposed to volatility, thereby posing risks to macro-financial stability.

The HKMA will continue to closely monitor the risks and vulnerabilities in the domestic and external environment, and stand ready to deploy appropriate measures to maintain monetary and financial stability in Hong Kong. Research programmes will examine issues affecting the economy and assess their potential risks. 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.

Banking Stability

The long-running European sovereign debt crisis and uncertainty over the recovery in the US continued to adversely impact on global financial markets in 2012, while low interest rates and fund inflows raised the risk of an asset-price bubble in Hong Kong. As a result, the HKMA maintained its supervisory focuses on the management of liquidity and credit risks by authorized institutions (AIs). The implementation of new automatic teller machine (ATM)-card technology to improve security was making good progress, and the supervision of AIs' compliance with anti money-laundering requirements was stepped up. Legislation to implement the first phase of the strengthened Basel standards was enacted; and efforts continued to enhance investor and consumer protection and education.

REVIEW OF 2012

Overview

Volatile financial market conditions continued into 2012 amid the prolonged European sovereign debt crisis, uncertain US economic recovery and slower growth in China. On the other hand, low interest rates and fund inflows increased the risk of an overheating property market. Against this backdrop, the HKMA continued to monitor closely AIs' management of liquidity and credit risks, funding strategy, mortgage lending, Mainland-related business (including renminbi business) and other areas of supervisory concern to ensure the banking sector remained resilient to any abrupt deterioration in the macroeconomic environment.

The HKMA continued to work closely with the industry towards the introduction of chip-based technology in ATM services by AIs in an effort to enhance ATM security. After the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO) came into effect on 1 April 2012, and following widely reported incidents overseas involving international banks with significant presence in Hong Kong, the HKMA increased its supervision of AIs' compliance with the Ordinance and the HKMA's Guideline on Anti-Money Laundering and Counter Terrorist Financing.

Operational supervision

After resumption of the usual examination cycle and with a slight increase in staff, the HKMA carried out 288 on-site examinations, compared with 198 in 2011 and 216 in 2010. Regular examinations covered areas such as corporate governance framework, compliance monitoring, credit-related issues and remuneration systems, while thematic and specialist examinations focused on selected AIs' credit and liquidity risk management, stress testing and regulatory compliance of Mainland-related business, including renminbi business. The number of reviews on AIs' internal ratings-based (IRB) models increased given their wider usage and the need to ensure that such models remained robust. Separately, 27 on-site examinations were conducted on AIs' sale of investment and insurance products as well as other areas of securities business.

The supervisory teams conducted 192 off-site reviews of AIs' financial position and business operations. Greater attention was paid to liquidity risk management, funding strategy and analysing the impact of the planned Basel III implementation on capital adequacy. The supervisory teams met the boards or board-level committees of 19 AIs and held tripartite meetings with the senior management and the external auditors of 13 AIs.

The Banking Supervision Review Committee considered seven cases, six of them concerning the authorization of AIs, and one relating to the investigation of an AI's practices in handling documents involving customer data.

The HKMA commissioned a report under section 59(2) of the Banking Ordinance, requiring the AI to appoint external auditors to review its anti-money laundering (AML) controls and report the findings to the HKMA.

No AI breached the requirements of the Banking Ordinance relating to capital-adequacy or liquidity ratios. There were 13 breaches of the requirements under section 20(4)(b) to notify the HKMA of changes to information recorded in the register maintained by the HKMA, six breaches of the requirements under section 72B to notify the HKMA of the appointment of managers and five breaches under section 85 regarding unsecured lending to AIs' employees. All the breaches were assessed to be unintentional. They were rectified promptly by the AIs and did not affect the interests of depositors.

Details of the operational supervisory work performed in 2012 are set out in Table 1.

Table 1 Operational supervision

		2012	2011
1	On-site examinations	**288**	198
	Regular examinations	**73**	39
	– risk-based	**58**	30
	– overseas	**15**	9
	Basel II — Reviews of the internal ratings-based approach (IRB approach) and internal models approach (IMM approach)	**22**	9
	– Follow-up examinations of the IRB approach	**15**	4
	– Internal model recognition assessment and review of the IMM approach	**7**	5
	Internal capital adequacy assessment process and economic capital/capital planning	**7**	8
	Credit risk management and asset quality	**34**	40
	Market risk and treasury activities	**9**	7
	Firm-wide stress testing and liquidity risk management	**13**	6
	Securities, investment and insurance products-related conduct examinations	**27**	30
	Compliance with representation requirements in the Deposit Protection Scheme Ordinance and Deposit Protection Scheme Representation Rules	**12**	7
	Code of Banking Practice/Consumer protection	**2**	1
	Positive mortgage data sharing	**3**	–
	Anti-money laundering and counter-terrorist financing controls	**14**	11
	IT, Internet banking and operational risk	**20**	18
	Remuneration system[@]	**–**	10
	Mainland-related business	**15**	9
	Renminbi payment system	**–**	1
	Renminbi business	**37**	2
2	Off-site reviews and prudential interviews	**192**	193
3	Tripartite meetings	**13**	1
4	Meetings with board of directors or board-level committees of AIs	**19**	8
5	Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	**199**	223
6	Reports commissioned under section 59(2) of the Banking Ordinance	**1**	4
7	Cases considered by the Banking Supervision Review Committee	**7**	10
8	AIs subject to the exercise of powers under section 52 of the Banking Ordinance	**1**	1

[@] In 2012, examinations of remuneration systems formed part of the risk-based examinations of the selected AIs.

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 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 2012. 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 keep in view 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 AIs. The AIs were notified of the ratings and given the opportunity to request a review, although none did so.

Specialised supervisory work

Supervision of technology risk

The growth in the use of Internet banking services continued. By the end of the year, the number of personal Internet banking accounts reached 8.4 million (from 7.7 million in 2011), and there were 764,000 corporate Internet banking accounts (up from 658,000 in 2011). Among the 71 AIs offering Internet banking services, 63 (including all of the 46 that offer high-risk transactions through Internet banking such as fund transfers to unregistered third-party accounts), have implemented two-factor authentication and some 4.3 million customers have registered for this service.

The HKMA continued to work with various parties to promote public security awareness of Internet banking. This included participating with the Hong Kong Association of Banks in a "Build a Secure Cyberspace" promotion campaign organised by the Hong Kong Police Force, the Office of the Government Chief Information Officer and the Hong Kong Computer Emergency Response Team Coordination Centre to raise the public awareness of cyber threats and the importance of information security.

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

The HKMA continued to work closely with the industry on the implementation of chip-based ATM technology to strengthen security controls for ATM services. The HKMA also worked with the industry to promote public awareness of the enhanced technology and security measures. Regular on-site examinations and off-site surveillance of AIs' controls over Internet banking, technology risk management and business continuity planning were conducted. Coverage of the supervisory control self-assessment process for Internet banking, technology risk management and business continuity planning was extended to 79 AIs (from 78 in 2011).

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

The annual self-assessment on operational risk management covered 74 AIs (77 in 2011). The exercise revealed that the selected AIs had in general established operational risk management frameworks in line with the supervisory requirements. The operational risk management specialist team conducted on-site examinations at five AIs to review their policies and controls on operational risk.

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 in supervising 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.

In response to market developments and observations from our supervisory work, the HKMA issued a series of circulars providing further guidance to AIs on the sale of investment products to bank customers to ensure adequate investor protection. These covered new investment products or services, such as Renminbi Qualified Foreign Institutional Investor (RQFII) funds and Hong Kong Exchanges and Clearing Limited's "Dual Tranche, Dual Counter" model.

Because of the special features and risks of debentures that are extendable, exchangeable, convertible or with non-viability loss absorption features, and funds primarily investing in high-yield bonds, the HKMA required AIs to audio-record face-to-face sales of such products to retail customers and to apply the pre-investment cooling-off period to these debentures.

In addition, the HKMA strengthened the regulation of sales by AIs of structured products not regulated by the Securities and Futures Ordinance (SFO), such as investment products linked to currencies and interest rates, by requiring AIs to apply the regulatory measures of the SFC (restriction on the use of gifts, investor characterisation, pre-sale disclosure of monetary and non-monetary benefits and disclosure of sales-related information) to the sale of such products. The HKMA also issued guidance in September reminding AIs to comply with the regulatory requirements in conducting MPF intermediary activities and to ensure that the sale, marketing and selection of constituent funds of MPF schemes in branches take place in the investment corner, and that cases involving risk mismatch are audio-recorded.

Because of the unique features of investment-linked assurance scheme (ILAS) products and to better protect the interests of potential policyholders, the HKMA has been working with the OCI and the SFC to formulate a proposal for enhanced disclosure requirements.

To facilitate the development of the private wealth management industry in Hong Kong, the HKMA has tried to provide a regulatory environment that is user-friendly for private banking customers while ensuring adequate investor protection. Through circulars issued to AIs, the HKMA introduced a flexible version of its enhanced measures for the sale of investment products to private banking and corporate banking customers, taking into account the differences in the clientele and mode of operations of these businesses and retail banking business. In close co-operation with the SFC, the HKMA also provided guidance and clarification to facilitate the adoption of a "portfolio-based" approach in assessing the suitability of investment solicitation and recommendation for private banking customers.

To encourage the adoption of common competency standards among industry practitioners, and to cater for the evolving demand of the industry for professional talent, the HKMA has been providing advice and assistance to the private wealth management industry, the Hong Kong Institute of Bankers (HKIB), the Hong Kong Securities and Investment Institute (HKSI) and the Treasury Markets Association (TMA) to develop an enhanced competency framework for private wealth management practitioners.

The HKMA specialist teams conducted 27 on-site examinations in 2012 covering areas including the sale of RQFII funds, accumulators and decumulators, ILAS and non-linked long-term insurance products; the selling process, product due diligence and training regarding investment products regulated under the SFO; the private banking "portfolio-based" approach to suitability assessment; error trade controls and private placements; and compliance with new or enhanced regulatory requirements for the sale of investment products.

The HKMA processed nine applications to become registered institutions (RIs) and four applications from RIs to engage in additional regulated activities. It also granted consent to 255 Executive Officers, who are responsible for supervising the securities activities of RIs, and conducted background checks on 8,452 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

During the year, the HKMA continued to work closely with the Financial Services and the Treasury Bureau (FSTB) and other financial regulators to prepare for the introduction of the statutory regime for regulating MPF intermediaries, which was implemented on 1 November along with the Employee Choice Arrangement. The HKMA also worked with the FSTB and the OCI to engage the banking industry and other stakeholders in formulating the future regulatory framework governing the distribution of insurance products under the proposed independent Insurance Authority.

Supervision of treasury activities

Given the increasing importance of liquidity risk management and firm-wide stress testing and the unstable market conditions, the HKMA concentrated its thematic on-site examinations for selected AIs in these areas. Of the 22 treasury examinations conducted, 13 covered liquidity risk management and firm-wide stress testing with the remaining nine focused on AIs' control frameworks for managing market, counterparty credit and interest-rate risks arising from their treasury and derivatives activities.

In addition to the on-site examinations, 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.

Supervisor-driven stress testing programme

To better understand the resilience of locally incorporated retail banks to extreme adverse economic conditions, the HKMA initiated a bottom-up supervisor-driven stress testing programme in late 2012. The forward-looking programme was designed to encourage AIs to develop plans to address potential problems in case economic conditions come under stress. The HKMA will analyse the stress test outcome prepared by individual AIs and discuss them with the participating AIs.

Credit risk management and asset quality

Credit growth and asset quality

The banking sector's total lending increased by 9.6%, compared with 20.2% in 2011 (Table 2). The overall loan-to-deposit ratio was stable, increasing slightly to 67.1% at the end of 2012, from 66.9% a year ago.

Table 2 Growth in loans and advances

% change	2012	2011
Total loans and advances	**9.6**	20.2
of which		
– for use in Hong Kong	**7.1**	12.5
– trade finance	**9.3**	27.9
– for use outside Hong Kong	**16.0**	41.9

Despite the moderation in credit growth, the HKMA continued to closely monitor AIs' lending practices to ensure that they remained prudent. The banking sector's overall asset quality remained sound with the classified loan ratio standing at 0.58% at the end of the year.

Prudential supervision of mortgage loans

With continuing signs of overheating in the property market and additional quantitative easing by the major developed economies, the risk of property-price bubbles in Hong Kong increased further. The HKMA remained vigilant towards AIs' property lending, particularly over the risk that borrowers with multiple outstanding mortgage loans might pose to AIs, and introduced on 14 September the fifth round of countercyclical macroprudential measures. Measures applicable to these borrowers included:

(1) lowering the maximum debt servicing ratio (DSR) from 50% to 40% and the maximum stressed DSR from 60% to 50%;

(2) lowering the maximum loan-to-value (LTV) ratio of property mortgage loans granted to net worth-based mortgage applicants by 10 percentage points to 30%; and

(3) lowering by 20 percentage points the maximum LTV ratios for property mortgage loans granted to mortgage applicants with income derived mainly from outside Hong Kong.

Besides, the HKMA required AIs to limit the maximum loan tenor of all new mortgage loans to 30 years as longer loan tenors would increase AIs' credit risk and weaken borrowers' ability to withstand interest rate risk. These measures apply to both residential and non-residential properties.

The HKMA also conducted a review of major AIs' underwriting policies for car park mortgages. The review identified a number of prudent underwriting practices for these loans including limits on LTV ratio, DSR and loan tenor. AIs were asked to ensure their underwriting policies are in line with such good practices.

The countercyclical measures introduced since 2009 on property mortgage loans have made banks more resilient to potential credit losses in a property market downturn. The average LTV ratio for new residential mortgage loans (RMLs) declined to 52% in December 2012 from 64% in September 2009 before the first round of measures was introduced. The average DSR for new RMLs decreased to 36% in December 2012 compared with 41% in August 2010, when the DSR requirement was tightened.

European sovereign debt crisis

The HKMA continued to closely monitor the funding and liquidity positions of foreign AIs, particularly those from Europe, to ensure the effectiveness of their liquidity risk management and contingent funding arrangements. Close communication was maintained with the home supervisors of some European AIs through regular teleconferences, attending supervisory colleges and participating in the work of crisis management groups.

Mainland-related business

Renminbi banking business

In view of the orderly and healthy development of renminbi business with greater market depth and breadth and improvements in AIs' risk management capability, the HKMA introduced several refinements to facilitate further business development.

First, adjustments in the calculation of the statutory liquidity ratio were introduced in February to allow for the inclusion of more renminbi liquefiable assets. Secondly, AIs were allowed to set their own internal renminbi net open positions in consultation with the HKMA from May. Thirdly, the 25% renminbi risk management limit, which required AIs to hold five specific types of liquid renminbi assets against their customer deposit liabilities, was replaced by a 25% supervisory renminbi liquidity ratio to bring the liquidity risk management framework for renminbi more in line with that for other major currencies. This also facilitated more accurate matching of maturity of renminbi liquid assets with short-term renminbi liabilities. In addition, the HKMA launched in June a renminbi liquidity facility to provide renminbi liquidity to AIs to address possible short-term renminbi liquidity tightness.

In August, the HKMA requested all AIs to have in place proper renminbi liquidity risk management policies and renminbi liquidity contingency plans to further consolidate the appropriate management of renminbi liquidity risk. All the policies and plans received from AIs are considered to be generally satisfactory.

Tapping the Mainland market

Thirteen locally incorporated banks have established business operations on the Mainland, of which eight operated through subsidiary banks incorporated on the Mainland. These banks continued to expand their branch networks during the year, maintaining over 400 Mainland branches or sub-branches, either directly or through subsidiaries. The HKMA conducted on-site examinations of these Mainland operations of Hong Kong banks.

The industry's aggregate on-balance-sheet non-bank exposures to the Mainland amounted to the equivalent of HK$2,415.3 billion at the end of 2012, or 14.3% of total assets. These included exposures of HK$620.8 billion booked at Mainland subsidiaries of Hong Kong banks. Compared with 2011, the aggregate on-balance sheet exposures grew by 18.8%.

With the increasing Mainland-related business conducted by AIs, the HKMA stepped up surveillance of these activities and requested the AIs concerned to report more detailed information on their non-bank Mainland exposures. As part of this initiative, the HKMA consulted the banking industry associations on the introduction of a new return on Mainland activities in 2013. Thematic examinations on AIs active in these areas were also conducted.

The HKMA continued to maintain close contact 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 AMLO and a guideline on the new legislative and regulatory requirements came into effect on 1 April. To help AIs meet the legal and regulatory requirements and provide guidance on how anti-money laundering and counter-terrorist financing (AML/CFT) systems and controls can be strengthened, the HKMA conducted a number of seminars, covering the implementation of the AMLO and common findings of on-site examinations.

To ensure AIs' systems and controls are effective and comply with the regulatory and legal requirements, the AML specialist teams completed 14 on-site examinations during the year, including four Tier-2 examinations and 10 thematic examinations.

Co-operation with supervisors outside Hong Kong

The HKMA participated in college-of-supervisors meetings organised by the home supervisors of 24 banking groups with significant operations in Hong Kong. Issues of common interest were discussed, including market trends, key areas of supervisory focus, stress testing, credit, liquidity, market and other types of risk management and supervisory issues relating to megabanks.

Bilateral meetings were held with banking supervisory authorities from Australia, France, Germany, India, Indonesia, Italy, Japan, the Mainland, the Netherlands, Singapore, South Korea, Switzerland, Taiwan and the UK. There were also regular exchanges with authorities outside Hong Kong on institution-specific issues and developments in financial markets.

The HKMA is a member of the crisis management groups of eight 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 principles established by the Financial Stability Board (FSB). As an FSB member, the HKMA also contributed its views on the cross-border resolution framework in the Cross-Border Crisis Management Working Group.

Basel Accord

Enhancements to Basel II

The Basel Committee on Banking Supervision's "Basel 2.5" enhancements to the regulatory capital framework were implemented in Hong Kong on 1 January through the Banking (Capital) (Amendment) Rules 2011 and Banking (Disclosure) (Amendment) Rules 2011. Under Basel 2.5, AIs are required to hold more regulatory capital for their market risk exposures and their exposures to securitisation transactions, particularly those with complex structure, to better capture the risks inherent in these exposures.

Implementation of advanced approaches

Approvals were granted during the year for another two AIs to adopt the internal models approach (IMM approach) for calculating market risk, following assessment of their internal models and market risk management systems against the minimum requirements in the Banking (Capital) Rules, as amended by the Banking (Capital) (Amendment) Rules 2011, which became effective on 1 January 2012. A review was also conducted into the compliance of AIs already using the IMM approach with the revised requirements. Following the review, all AIs concerned were granted approval to continue using the IMM approach except one AI which reverted to the standardised (market risk) approach upon the commencement of the amended Rules.

The HKMA conducted a thematic review of the approaches adopted by AIs using the internal ratings-based approach (IRB approach) for credit risk to the recognition of non-contractual support from related entities of borrowers in devising internal ratings for those borrowers and, specifically, the extent to which such ratings are enhanced by the perceived potential for such non-contractual support. The HKMA reviewed the robustness of the approaches to ensure that credit risk was not under-estimated.

Several AIs with approval to use the IRB approach for credit risk made changes to their internal rating systems during the year to reflect the availability of more comprehensive data and refinements to their methodology. The HKMA reviewed the changes to confirm the AIs' continued compliance with the requirements for the use of the IRB approach, taking into account both the extent of the changes and the materiality of their impact on the AIs' regulatory capital.

Supervisory review process

The supervisory review process (SRP) under Pillar 2 of the Basel II capital framework[2] provides the HKMA with a comprehensive framework for assessing the capital levels and risk profiles of Hong Kong-incorporated AIs. The SRP covers both credit and non-credit-related risks such as interest rate risk in the banking book as well as liquidity, reputation and strategic risks.

A round of SRP assessments on Hong Kong-incorporated AIs was completed and the SRP Approval Committee reviewed the results to consider both the appropriate minimum capital adequacy ratio (CAR) that individual AIs should maintain and whether there were other supervisory issues warranting attention. AIs were notified of the results, and were given the opportunity to request a review of their minimum CAR, although none did so.

2 The Basel Committee's regulatory capital framework has three mutually reinforcing Pillars, respectively dealing with the calculation of capital requirements for credit, market and operational risks (Pillar 1), the institution of a supervisory review process for determining the capital adequacy of banks (Pillar 2) and the associated disclosure standards (Pillar 3).

Basel III

Implementation of Basel III in Hong Kong

A major focus for the HKMA in 2012 was the completion of the legislative process for the introduction in Hong Kong of the first phase of the Basel Committee on Banking Supervision's Basel III standards.

In February 2012, the Banking (Amendment) Bill 2011 (the Bill) was passed by the Legislative Council (LegCo), and became the Banking (Amendment) Ordinance 2012 (BAO 2012), to empower the Monetary Authority to make rules prescribing the capital, liquidity and disclosure requirements for AIs and to approve and issue codes of practice to provide guidance for such rules.

In December, the Banking (Capital) (Amendment) Rules 2012 (BCAR 2012), made under powers introduced by the BAO 2012, completed the LegCo's negative vetting to bring into effect the first phase of Basel III from 1 January 2013, in accordance with the Basel Committee's transition timeline.

Capital standards

Pillar 1

The first phase of Basel III focuses on capital standards. The regulatory capital framework is strengthened by: improving the quality of the regulatory capital base, focusing on the ability of capital instruments to absorb losses as a going concern and recognising the pre-eminence of common equity for this purpose; raising the minimum regulatory capital requirements by requiring banks to meet three risk-weighted ratios (of Common Equity Tier 1 Capital, Tier 1 capital and Total capital respectively against risk-weighted assets); and broadening the risk coverage of the framework on counterparty credit risk (CCR) exposures of banks. The HKMA undertook extensive consultation with the banking industry on its policy proposals for implementing these standards, culminating in the third quarter with a formal statutory consultation involving the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks, and the DTC Association pursuant to section 97C of the Banking Ordinance.

The HKMA took the opportunity of the passage of the BCAR 2012 to introduce an internal models calculation approach for CCR (IMM CCR approach) as an alternative method for authorized institutions (AIs) to calculate their CCR exposures arising from over-the-counter derivatives transactions. AIs using the internal models approach to calculate their market risk capital charge may apply to the HKMA for approval to use the IMM CCR approach instead of the existing "current exposure method" to calculate their CCR exposures for capital adequacy ratio purposes.

Pillar 2

Basel III focuses primarily on the Pillar 1 requirements of the regulatory capital framework (the calculation of regulatory capital for credit, market and operational risk). It does not provide specific guidance on the application of Pillar 2 (the supervisory review process (SRP) and any resulting additional capital requirements which may be imposed to cover risks not adequately covered in Pillar 1) and how any Pillar 2 capital add-on relates to the new Basel III risk-weighted capital ratios and capital buffers. Therefore, to integrate Pillar 1 and Pillar 2, the HKMA has revised its supervisory guideline "Supervisory Review Process" to introduce changes to the local Pillar 2 framework necessitated by the implementation of Basel III, and explain how the revised Pillar 2 framework will operate under Basel III. The approach taken reflects the underlying philosophy of Pillar 2 as well as local circumstances and the approaches adopted in other major jurisdictions.

Basel III (continued)

The basic concept and principles underlying the SRP are retained and consequently the Pillar 2 capital add-on will continue to form a constituent part of an AI's minimum capital requirements to ensure that sufficient capital is held by the AI against both Pillar 1 and Pillar 2 risks. However, the SRP assessment framework is adjusted to address any potential overlap between Pillar 2 capital and the Basel III capital buffers when the latter come into effect in 2016.

After industry consultation, the revised SRP guideline was formally issued on 28 December for implementation from 1 January 2013.

Pillar 3

In November, the HKMA issued draft Banking (Disclosure) (Amendment) Rules for formal statutory consultation with industry bodies pursuant to section 60A of the Banking Ordinance. The Rules primarily implement disclosure requirements associated with the first phase of the Basel III capital standards and reflect the *Composition of capital disclosure requirements* released by the Basel Committee in June.

Capital buffers

The two capital buffers introduced by Basel III are scheduled to be implemented from 2016. The capital conservation buffer requires a bank to hold additional Common Equity Tier 1 Capital equal to 2.5% of its risk-weighted assets if it is to avoid having restrictions placed on its ability to make distributions such as dividend payments, or share buybacks or discretionary staff bonus payments. The countercyclical buffer, which is also composed of Common Equity Tier 1 Capital can vary between 0% and 2.5% of a bank's risk-weighted assets. The countercyclical buffer should be activated (set at a level in excess of 0%) in times of excessive credit growth with systemic implications.

National authorities will, therefore, require frameworks for the surveillance of the build-up of systemic risk and for the activation (and release) of the countercyclical buffer at appropriate times. The HKMA is currently working to identify specific indicators that may be good predictors of system-wide risk build-up in Hong Kong for the purpose of "switching on" the buffer, and also the metrics that may indicate the "turning point" in the economic cycle and signal the need for a buffer release to allow AIs to continue lending into a downturn.

Liquidity standards and monitoring tools

In addition to strengthening regulatory capital requirements, Basel III introduces two new global liquidity standards, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), to improve banks' resilience to liquidity stress.[3] A complementary set of liquidity monitoring tools has also been developed for supervisors' surveillance of banks' liquidity risk exposure to further strengthen and promote consistency in liquidity risk supervision globally.

The HKMA intends to follow the Basel Committee timetable and implement the LCR on 1 January 2015 and the NSFR on 1 January 2018. The HKMA also proposes to adopt the liquidity monitoring tools recommended by the Basel Committee as part of its ongoing supervisory process from 1 January 2015.

3 The LCR is designed to promote banks' short-term liquidity resilience by ensuring that they have sufficient high-quality liquid assets (HQLA) to survive for at least 30 days under an acute stress scenario. The NSFR promotes 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.

Basel III (continued)

Ultimately, the liquidity standards will be set out in the Banking (Liquidity) Rules to be made by the Monetary Authority under the power conferred by the BAO 2012, supplemented where necessary by codes of practice and supervisory guidelines.

In 2012, the HKMA began consulting the banking industry on initial policy proposals for implementing the Basel III liquidity standards in Hong Kong. This included consultation on, among other proposals, a two-tier approach for applying the liquidity standards, under which larger and more sophisticated AIs of greater significance to the Hong Kong banking system will be required to observe the LCR, while others will observe a modified version of the existing 25% minimum liquidity ratio in the Banking Ordinance.

The HKMA's industry consultation on the liquidity standards will continue in 2013 taking into account the Basel Committee's revisions to the LCR published in January 2013.

SIFI framework

The Financial Stability Board and the Basel Committee continued to work on the implementation of the policy framework for systemically important financial institutions (SIFIs) to address the systemic and moral hazard risks associated with such institutions. The FSB issued its first annual update to the list of globally systemically important banks (G-SIBs) in November and, for the first time, allocated the G-SIBs to "buckets" corresponding to a required level of additional loss absorbency (in essence, an additional capital requirement levied on G-SIBs). The level of additional loss absorbency currently ranges from 1% to 2.5% of the relevant G-SIBs' risk-weighted assets, with an empty top bucket of 3.5%. The additional loss absorbency requirements for G-SIBs will be phased in from 2016 (initially for banks identified as G-SIBs in November 2014).

Work also progressed on extending the SIFI framework beyond G-SIBs to other systemically important financial institutions. In October, the FSB endorsed a set of principles drawn up by the Basel Committee for a domestic systemically important bank (D-SIB) framework. The 12 principles focus primarily on a methodology for assessing whether a bank is a D-SIB and on the higher loss absorbency requirement (in terms of additional capital) which a D-SIB should hold. National authorities should begin applying the requirements to banks identified as D-SIBs from January 2016. Preliminary work is now underway at the HKMA to devise a D-SIB framework, and industry consultation will be undertaken during 2013.

Supervisory reporting

In December, the HKMA released proposed revisions to the regulatory banking return relating to capital adequacy to reflect the changes made by the BCAR 2012 and enable AIs to report their capital positions by reference to the new capital requirements. AIs are expected to report their capital positions as at the end of March 2013 using the revised return.

Basel III (continued)

HKMA's participation in Basel III working groups

As a member of the Basel Committee, the HKMA has continued to participate in the Committee's work on the implementation of the Basel III framework. The HKMA is represented on the Committee's Working Groups on Liquidity, Capital[4] and Disclosure[5] as well as its Quantitative Impact Study Working Group, which have been tasked with addressing outstanding issues relevant to the application of the Basel III standards. Some of these issues are of particular relevance to Hong Kong, such as the development of a framework to allow jurisdictions with an insufficient supply of HQLA denominated in their local currency to adopt an alternative treatment under the LCR to cover their banks' potential liquidity needs.

Basel III implementation monitoring process

The HKMA contributed data from selected Hong Kong-incorporated AIs to the Basel Committee's quantitative impact studies to facilitate the assessment of the impact of the Basel III requirements and the monitoring of banks' progress in implementation. This monitoring is expected to be repeated semi-annually during the transition period prior to full implementation of the Basel III framework in 2019.

The HKMA also carried out a similar implementation monitoring exercise locally covering a broader sample of AIs. The results to date indicate that AIs in Hong Kong should be generally well placed to meet the new capital standards, given their tendency historically to maintain capital levels above the regulatory minimum and to rely principally on common equity to meet 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 requirements. The information collected in the quantitative impact studies has enabled the HKMA to better assess the effects of the liquidity standards on different types of AIs (such as those that are incorporated outside Hong Kong, wholesale-oriented in their business, or predominantly retail-based in their focus) and obtain some insight into the likely behavioural changes of AIs in response to the standards.

HKMA's participation in the Basel Committee's Regulatory Consistency Assessment Programme

The HKMA led the international expert team that assessed the consistency of existing and proposed banking regulations in the United States with the Basel II and Basel III standards as part of the Basel Committee Regulatory Consistency Assessment Programme (RCAP). Similar assessments were conducted by other teams for the European Union and Japan. The three assessment reports were published by the Basel Committee in September. Ultimately, all of the Basel Committee's member jurisdictions, including Hong Kong, will be assessed under the RCAP. The RCAP assessment for Singapore began in the last quarter of 2012, and will be followed by assessments of Switzerland, China, Australia, Brazil and Canada in 2013 and 2014.

4 The Working Group on Capital is a new working group formed in 2012 by the merger of the former Definition of Capital Subgroup and the former Contingent Capital Working Group.

5 The Working Group on Disclosure is a new working group formed in 2012 by the Basel Committee, principally to review and co-ordinate disclosure initiatives by the Committee and other relevant bodies, to ensure a single and coherent package of Pillar 3 disclosure requirements.

Improving supervisory policy framework

Stress testing

A revised module "Stress-testing" in the Supervisory Policy Manual was issued in May, following industry consultation. The module incorporates the *Principles for Sound Stress Testing Practices and Supervision* issued by the Basel Committee on Banking Supervision in May 2009.

Corporate governance

Revised supervisory guideline "Corporate Governance of Locally Incorporated Authorized Institutions" was issued following industry consultation in August. The guideline sets out the HKMA's supervisory expectations for the corporate governance of Hong Kong-incorporated authorized institutions (AIs), reflecting the *Principles for Enhancing Corporate Governance* issued by the Basel Committee in October 2010. The guidance focuses on board and senior management oversight (including their respective roles in risk governance), the functioning, organisation and evaluation of the board, and the disclosure of key corporate governance and risk management information.

Large exposure limits

A working group of the Basel Committee is developing proposals for global standards regulating banks' large exposures. Although many jurisdictions, including Hong Kong, currently apply restrictions on large exposures, there is at present no internationally harmonised standard. A consultation document was issued by the Basel Committee in March 2013. Once the regime is finalised, the HKMA will update the regulations for AIs to align them with the new international standard.

Use of internal models approach to calculate market risk

Revised supervisory guideline "Use of Internal Models Approach to Calculate Market Risk" was issued in October, following industry consultation, to reflect the enhancements to the IMM approach for market risk set out in the Banking (Capital) (Amendment) Rules 2011.

Other policy development work

Additional policy development work undertaken by the Basel Committee during the year included consultation on proposals to reform the regulatory capital framework for banks' trading book exposures, following a fundamental review; the development of a set of indicators for monitoring banks' intraday liquidity risk to complement the relevant guidance in the Basel Committee's 2008 *Principles for Sound Liquidity Risk Management and Supervision*; and updating the guidance on the management of risks associated with the settlement of foreign exchange transactions. The HKMA provided comments during the development of these proposals, taking into account local circumstances and practices.

The global financial crisis drew attention to the need to focus on risk at both the system-wide and individual institution levels. The HKMA has, therefore, been examining the systemic risk issues that may be most relevant to Hong Kong and the range of existing and potential macroprudential policy options to most effectively address them. Areas where further and more in-depth work is needed have been identified.

Accounting standards

In response to the call by the Group of Twenty (G20) for a single set of global accounting standards to be adopted to strengthen financial supervision and regulation, the International Accounting Standards Board and the US Financial Accounting Standards Board have continued their efforts to develop convergent and improved standards. Improving accounting standards for the classification and measurement of financial instruments and loan loss provisioning are of significant importance to the banking industry and of particular interest to prudential regulators.

The HKMA and the Banking Regulatory Liaison Group of the Hong Kong Institute of Certified Public Accountants (HKICPA) held regular discussions during the year on topics of common interest. These included developments in international accounting convergence, new accounting and financial reporting standards issued by the HKICPA and their implications for the banking industry, and key supervisory policy developments domestically and internationally.

Consumer protection

Code of Banking Practice

The industry's overall compliance with the Code of Banking Practice remained satisfactory. In the industry's self-assessment covering the period from 1 January to 31 December 2011, all AIs reported full, or almost full, compliance.[6] The HKMA also conducted thematic examinations on two AIs to review their compliance with the Code and related policies and controls. The Code of Banking Practice Committee, on which the HKMA is represented, began a review of the Code to further enhance practices. The review will continue in 2013.

Establishment of the Investor Education Centre and the Financial Dispute Resolution Centre

The HKMA contributed towards the establishment of the Investor Education Centre (IEC) and the Financial Dispute Resolution Centre (FDRC). The FDRC commenced operation in June to provide financial consumers with an independent and affordable mediation and arbitration avenue to resolve monetary disputes with financial institutions. The IEC, established as a wholly-owned subsidiary of the SFC, is a cross-sectoral investor education body which aims to improve financial literacy and the public's ability to make better financial decisions. It was officially launched in November.

G20 High-level Principles on Financial Consumer Protection

The HKMA continued to participate in the Task Force on Financial Consumer Protection of the Organisation for Economic Co-operation and Development (OECD) to develop effective approaches to support the implementation of the *G20 High-level Principles on Financial Consumer Protection*.

Credit data sharing

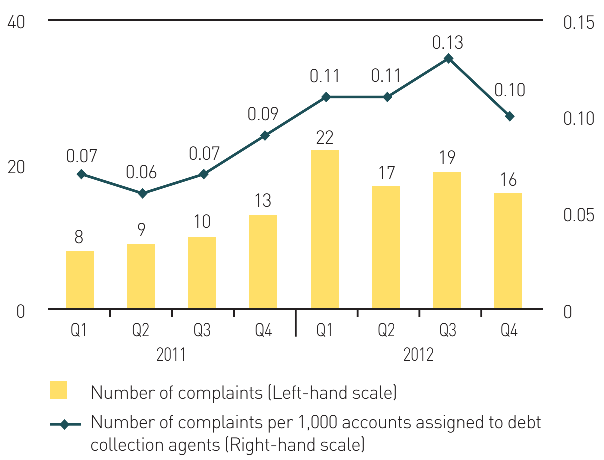
At the end of 2012, 116 AIs and AIs' subsidiaries were sharing commercial credit data through the Commercial Credit Reference Agency (CCRA). The scheme contained the credit data of more than 126,000 business enterprises, about 19% of which were sole proprietorships and partnerships. The continued development of the CCRA has helped to strengthen the credit risk management capacity of AIs. With regard to consumer credit data sharing, the HKMA conducted three on-site examinations to review AIs' compliance with the regulatory requirements in relation to the positive mortgage data sharing scheme and related policies and controls.

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

Customer complaints relating to debt collection agents employed by AIs

The number of complaints received by AIs about their debt collection agents increased to 74 from 40 in 2011 (Chart 1). The HKMA will continue to ensure that AIs properly monitor the conduct of their debt collection agents.

Chart 1 Complaints received by AIs about their debt collection agents



Financial consumer education

The HKMA, jointly with the OECD and the SFC, hosted an Asian Seminar on financial consumer protection and education and an Asia Financial Consumer Protection Roundtable on 13 and 14 December. The Seminar attracted over 120 local and overseas participants, including representatives of regulatory authorities, financial industry practitioners, consumer and investor education bodies and academics. Around 30 senior representatives of local and overseas supervisory authorities and public bodies responsible for financial consumer protection attended the Roundtable. Participants discussed the key lessons from the global financial crisis and recent developments to support financial consumer protection, and exchanged views on challenges in developing and implementing financial consumer protection policies in their jurisdictions.

To promote consumers' understanding of their rights and obligations, the HKMA, in December, launched a "Consumer Corner" on its website providing information on local banking consumer issues and the HKMA's role in banking conduct regulation.

Enforcement

Enforcement work

Apart from a small number of outstanding cases, some of which were lodged only recently, the handling of Lehman Brothers-related complaints was largely completed. Some 88% of the complaints were resolved and the remaining 12% closed because of insufficient evidence or grounds on which to proceed. With the majority of cases completed, the HKMA has begun redeploying resources to accelerate the handling of other complaints.

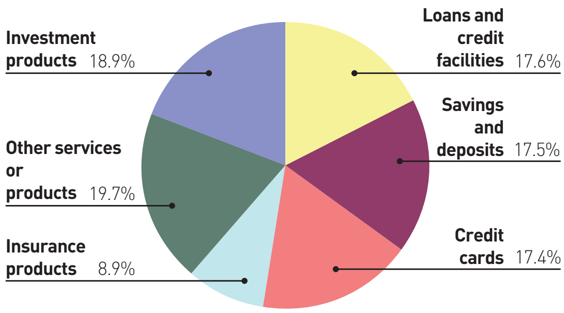
The HKMA received 916 formal banking complaints during the year (Table 3). The services or products concerned mainly included investment products, loans and credit facilities, savings and deposits, and credit cards (Chart 2).

Table 3 Banking complaint cases received by the HKMA

	2012			2011
	Conduct issue	**Service quality issue/ commercial dispute**	**Total**	Total
In progress on 1 January	1,509	418	**1,927**	3,281
Received during the year	273	643	**916**	834
Completed during the year	(1,067)	(463)	**(1,530)**	(2,188)
In progress on **31 December**	715	598	**1,313**	1,927

Note: These cases include both Lehman Brothers-related and non-Lehman Brothers-related formal banking complaints, as well as other cases referred by the HKMA's banking departments and other regulators.

Chart 2 Types of service or product concerned in banking complaints received by the HKMA



Assessments of 984 cases and investigations of 546 cases were completed, and 58 cases were opened by the Event Review Committee for further investigation. At the end of December, 1,313 cases were in progress (Table 3).

Investigations and recommendations by the HKMA have contributed towards the SFC taking the following enforcement action in 2012 under the SFO:

- reprimanded a bank, with the bank agreeing to repay more than US$11 million to customers, under a settlement agreement relating to more than 3,000 secondary market transactions of over-the-counter bonds, options and structured notes
- exercised its disciplinary power to ban a former relevant individual from re-entering the industry for three years.

The Ombudsman's Awards 2012

The HKMA was the runner-up in the Ombudsman's Awards 2012, following the overhaul of the Enforcement Department's banking complaint handling and enforcement process in 2011 to improve the efficiency and transparency of the complaint handling procedures. The award recognised the HKMA's effective internal administrative systems, professionalism in handling complaints, and commitment to improving its quality of service to the public. The Ombudsman also appreciated the HKMA's co-operative attitude in response to his Office's inquiries, its openness to recommendations and proactive attitude to introducing improvements.

Commencement of new legislation

The AMLO which came into effect on 1 April empowers the HKMA to investigate, discipline and prosecute contraventions of specified provisions by banks. The HKMA, following consultation with the banking industry, issued the guideline "Exercising Power to Impose Pecuniary Penalty", which took effect on 1 July. In October, the Anti-Money Laundering Regulatory Enforcement Co-ordination Group was established to provide a regular forum for the four relevant authorities under the AMLO (the HKMA, the Customs and Excise Department, the OCI and the SFC) to exchange views and observations and share the outcome of investigations and enforcement work in relation to the AMLO. The forum facilitates the performance of regulatory functions under the Ordinance and helps ensure consistency in enforcement outcomes.

Following the enactment of the Mandatory Provident Fund Schemes (Amendment) Ordinance 2012, a statutory regime for MPF intermediaries came into effect on 1 November. The HKMA, as frontline regulator, is vested with powers to investigate suspected contraventions in relation to the MPF intermediary activities of banks. The HKMA has worked closely with the Mandatory Provident Fund Schemes Authority and will enter into a memorandum of understanding in the first half of 2013 setting out, among other things, operational arrangements for handling complaints against banks concerning MPF products. The operational arrangements are designed to assist the public in lodging complaints, while ensuring regulatory consistency.

Deposit Protection Scheme

The Deposit Protection Scheme (DPS) continued to provide protection for deposits of up to $500,000 per depositor per bank. Taking into account the results of the Peer Review on Deposit Insurance Systems commissioned by the Financial Stability Board over its 24-member jurisdictions, a thorough self-assessment was conducted of the design of the DPS against the *Core Principles for Effective Deposit Insurance Systems* jointly issued by the Basel Committee and the International Association of Deposit Insurers. The assessment concluded that the DPS was largely well positioned against the Core Principles, although certain areas for possible further enhancement were identified, such as improving payout efficiency.

A full-scale rehearsal was conducted in the fourth quarter to test the ability of the Hong Kong Deposit Protection Board (HKDPB) and its network of payout agents to handle a payout in case of a bank failure. The rehearsal covered processes from the triggering of a payout to the delivery of compensation payments. The results confirmed that the HKDPB and its payout agents were able to operate in a co-ordinated and efficient manner to effect compensation payments in accordance with the established policies and procedures. A plan is being formulated to further improve payout efficiency following the review against the Core Principles and based on recommendations arising from the rehearsal. These include setting out an overpayment risk management process to support a faster payout, studying payment methods other than cheques, closer co-ordination between the HKMA, the HKDPB and other relevant government departments in a payout, and some fine-tuning of the payout system and procedures.

To monitor compliance with the DPS Representation Rules by DPS member banks, Scheme members' disclosures to depositors of their DPS membership and the protection status of their financial products were subject to an annual self-assessment by Scheme members and on-site examinations by the HKMA. The results were generally satisfactory and no significant non-compliance was identified.

Efforts were made to increase public awareness of the DPS, including a new multi-media publicity campaign. The results of an independent opinion survey indicated that public awareness rose to a record high of 78% after the campaign, with respondents' understanding of the $500,000 protection limit reaching 76%. There were also further initiatives to promote the DPS to target demographic groups, including a series of consumer events at the community level.

Oversight of clearing and settlement systems

Oversight of designated systems

The Clearing and Settlement Systems Ordinance (CSSO) empowers 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. Its purpose is to promote the general safety and efficiency of the designated systems: the Central Moneymarkets Unit, 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 addition to meeting the CSSO requirements, designated systems are expected to comply with the international standards for clearing and settlement systems. In April, the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the International Organization of Securities Commissions (IOSCO) published a report *Principles for Financial Market Infrastructures*, setting out new international standards for financial market infrastructures (FMIs), including systemically important payment systems, securities settlement systems, central securities depositories, central counterparties and trade repositories. The HKMA considers all designated systems as meeting the definition of FMI and has adopted the PFMIs into its oversight framework for designated systems by amending the "Guideline on the Oversight Framework for Designated Systems".

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. The HKMA participated in various meetings and teleconferences of the CLS Oversight Committee during the year and reviewed documents related to the operations and developments of the CLS system to ensure it continued to meet the safety and efficiency requirements under the CSSO.

In 2012, the HKMA became a member of the SWIFT Oversight Forum. SWIFT is a major global message carrier for financial institutions and market infrastructures. The Forum, chaired by the National Bank of Belgium and comprising member economies that are major users of SWIFT's services, discusses SWIFT oversight matters and shares SWIFT-related information. The HKMA has an interest in SWIFT's operations because AIs and designated systems in Hong Kong use, and rely on, the services of SWIFT and may be exposed to risks in the event of any disruption to its operations. The HKMA attended meetings of the Forum in May and November.

The HKMA also co-operates with other central banks in the oversight of foreign currency payment systems in Hong Kong. In particular, arrangements are maintained with other central banks for payment-versus-payment (PvP) links 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 Monetary Authority 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 2012 and reviewed four regular reports and 21 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 to fulfil the designation criteria of 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 2012, OCL completed its 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 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 and adverse impact on Hong Kong cardholders. In the annual self-assessment report covering activities in 2012, 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 2012, Hong Kong had 155 licensed banks, 21 restricted licence banks, 24 deposit-taking companies and 14 approved money brokers. During the year the HKMA granted four bank licences to four foreign banks and one restricted bank licence to a locally incorporated subsidiary of a foreign bank. One licensed bank, two deposit-taking companies and one money broker revoked their authorizations during the year.

The HKMA conducted a review of the market entry criteria for banks in the first half of 2012 and introduced changes to put the licensing requirements of Hong Kong on a par with those of other international financial centres. The requirements that an applicant for a banking licence must have total customer deposits of not less than $3 billion and total assets of not less than $4 billion were removed as was the requirement that a bank wishing to enter the Hong Kong market by establishing a locally-incorporated entity must previously have operated in Hong Kong as a branch, restricted-licence bank or deposit-taking company for at least three years.

The HKMA introduced in August face-to-face meetings with selected candidates applying for appointment as director, chief executive and alternate chief executive of locally incorporated AIs. The HKMA considers the arrangement a useful way to raise the standards of governance in locally incorporated AIs, and to help ensure that directors and senior management are fit and proper for their roles. The HKMA will continue to conduct meetings with selected candidates as part of the assessment process.

International co-operation

The HKMA continues to participate in various international and regional forums for banking supervisors. The HKMA is currently a member of both the Basel Committee and its governing body, the Group of Governors and Heads of Supervision and is represented on various Basel Committee working groups, including the Policy Development Group, the Standards Implementation Group, the Working Group on Liquidity, the Working Group on Capital, the Quantitative Impact Study Working Group, the Large Exposures Group, and the Working Group on Disclosure. The HKMA also participates in the Basel Committee and IOSCO joint 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 FSB Resolution Steering Group and the Cross-border Crisis Management Working Group. Regionally, the HKMA is a member of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and the South East Asia, New Zealand and Australia Forum of Banking Supervisors.

The HKMA also participates in committees and working groups under the Bank for International Settlements and EMEAP related to payment systems oversight. During the year, it participated in discussions with the CPSS and IOSCO to develop the PFMIs and the related disclosure framework and assessment methodology for FMIs.

PLANS FOR 2013 AND BEYOND

Supervisory focus

Against the background of continuing low interest rates and uncertain global economic conditions, property mortgage lending will remain a key focus of the HKMA's supervisory agenda in 2013. Separately, while credit growth in the banking sector moderated in 2012, it will remain an area of supervisory attention, particularly in ensuring AIs are well prepared for any sharp adverse change in economic conditions that may have a material impact on their asset quality. In addition, supervisory focus on AIs' Mainland-related business will be further strengthened in 2013.

Supervision of technology risk

The HKMA will maintain its regular on-site examinations and off-site surveillance of AIs' controls over Internet banking, technology risk management and business continuity planning to ensure the sound implementation of chip-based ATM security controls, while working with the industry to promote public awareness of the new security measures.

Supervision of operational risk

The HKMA's operational risk management specialist team will conduct on-site examinations and off-site reviews to identify and address emerging operational risks, and ensure that AIs have the requisite systems and controls to identify and manage their operational risk exposures. Supervision will continue to focus on assessing the effectiveness of AIs' operational risk governance frameworks and related risk-management tools.

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

The HKMA will:

- continue to work closely with the SFC and the banking industry to provide further guidance on the standards the HKMA expects institutions to observe in the sale of investment products

- continue to assist the private wealth management industry, the HKIB, HKSI and TMA to develop a structured framework covering competency requirements and continuing professional development for private wealth management practitioners

- continue to work closely with the OCI, the SFC and the banking industry to enhance the disclosure requirements relating to the sale of ILAS to ensure an appropriate degree of policyholder protection

- continue to co-operate with the FSTB and the OCI in enhancing the regulatory regime for insurance intermediary activities under the proposal to establish an independent Insurance Authority

- continue off-site and on-site surveillance of AIs' business conduct in selling securities, MPF and other investment and insurance products

- introduce a mystery shopping exercise on AIs' sale of investment and insurance products.

Supervision of AIs' compliance with guidance on liquidity risk management and stress testing

To assess AIs' compliance with the standards and guidance set out in the new module "Sound Systems and Controls for Liquidity Risk Management" in the Supervisory Policy Manual, issued in April 2011, and the revised module "Stress-testing", issued in May, the HKMA will conduct another round of thematic on-site examinations on these areas for selected AIs. In addition, the HKMA will continue to give priority to on-site examinations of AIs' treasury and derivative activities and surveillance of potentially important emerging risks.

Supervisor-driven stress testing programme

The HKMA will devote adequate resources to further developing the supervisor-driven stress testing programme.

Mainland-related business

In light of the rapid growth in AIs' Mainland-related business, the HKMA will strengthen its surveillance to ensure that the associated risks are assessed and managed appropriately. In particular, on-site examinations of AIs' Mainland-related activities will focus on credit underwriting standards and regulatory compliance. In addition, the HKMA will further strengthen its supervisory co-operation with the China Banking Regulatory Commission.

Prevention of money laundering and terrorist financing

The Financial Action Task Force promulgated the revised international anti-money laundering standards in 2012. The HKMA is now assisting the FSTB to review Hong Kong's AML/CFT regime and will implement appropriate changes where necessary.

The HKMA will continue to conduct institution-specific and thematic examinations to ensure that AIs' AML/CFT systems and controls meet legal and regulatory requirements and can effectively counter the risk of money laundering and terrorist financing.

Co-operation with supervisors outside Hong Kong

A key item on the HKMA's supervisory agenda will be to work with the relevant crisis management groups for international banks on formulating recovery and resolution plans in accordance with the timetable set by the Financial Stability Board. Every effort will be made to ensure the timely sharing of bank-specific prudential information and other issues of common interest, such as the latest financial condition of European banks and the implementation of recapitalisation plans.

Basel III

Capital standards

Policy development

The second phase of implementation of the Basel III capital standards will focus on introducing the capital conservation and countercyclical buffers designed to reinforce banks' resilience and reduce the impact of any economic downturn on their lending and other credit intermediation activities.

The capital conservation buffer will be phased in between 2016 and 2018 in accordance with the transition timeline of the Basel Committee on Banking Supervision.

The countercyclical buffer, when triggered, operates as an extension of the capital conservation buffer and, therefore, its framework should be established to coincide with the introduction of the capital conservation buffer. The countercyclical buffer will be set at 0% in normal times but, where excessive credit growth in a given jurisdiction is judged by the relevant authority in that jurisdiction to be associated with a build-up of system-wide risk, that authority may set a countercyclical buffer requirement above 0% for its own banks. Other regulators are then expected to follow suit for their banks' activities in that jurisdiction on a reciprocal basis. Since banks will need a period of notice (the Basel Committee suggests 12 months) to enable them to build up their capital once the countercyclical buffer is triggered, the operational framework for the countercyclical buffer should be in place from 2015 (i.e. 12 months before the buffers come into effect). Therefore, amendments to the Banking (Capital) Rules will be introduced in 2013/2014 to provide for the operation of the buffers.

Authorized institutions (AIs) assessed by the HKMA to be domestic systemically important banks (D-SIBs) will be subject to additional loss-absorbency requirements (additional capital requirements) reflecting the standards set out in *A Framework for Dealing with Domestic Systemically Important Banks* issued by the Basel Committee in October. The additional loss-absorbency requirement will be applied through an extension of the capital conservation buffer.

The HKMA expects to consult the industry during 2013 on the proposed amendments to the Banking (Capital) Rules to cater for the operation of the buffers and on the detailed policy proposals for the application of the D-SIB and countercyclical buffer frameworks.

Supplementary guidelines

The Banking (Capital) (Amendment) Rules 2012 (BCAR 2012) will necessitate consequential changes to existing supervisory guidance, including:

- **Counterparty credit risk** — the supervisory guideline "Counterparty Credit Risk Management" will be reviewed to bring it into line with the BCAR 2012 (including, in particular, the introduction of the internal models calculation approach for counterparty credit risk (IMM CCR approach)) and to reflect the enhanced counterparty risk management practices introduced by Basel III. The revised guideline will also provide guidance on credit valuation adjustment, i.e. adjustment for potential mark-to-market losses on derivative contracts due to changes in counterparty creditworthiness

Basel III (continued)

- **Overview of capital adequacy framework** — the HKMA is updating its "Overview of Capital Adequacy Regime for Locally Incorporated Authorized Institutions" to reflect the new capital adequacy regime introduced by the Banking (Amendment) Ordinance 2012 and BCAR 2012. The revised guidance will be issued for industry consultation in 2013

- **Financial instrument fair value practices** — similarly, the HKMA will update its guideline "Financial Instrument Fair Value Practices" to reflect the new definition of capital introduced under Basel III. The HKMA expects to issue a draft of the revised guidance for industry consultation in the first half of 2013

To address the technical issues which inevitably arise on the implementation of complex rules such as the BCAR 2012, the HKMA will issue "Frequently Asked Questions" as a swift and responsive measure to clarify interpretation and facilitate consistency in the application of the Rules.

Disclosure

To enable the Banking (Disclosure) (Amendment) Rules to take effect from 30 June 2013 in accordance with the Basel Committee's implementation timetable, it is planned to gazette and table the Rules before Legislative Council (LegCo) for negative vetting in April 2013. AIs will be required to observe the new standards for disclosures relating to a balance sheet date on or after 30 June 2013. To facilitate compliance and comparability between AIs, the HKMA will issue a set of standard disclosure templates within the first half of 2013.

Leverage ratio

Basel III introduces a simple non risk-based leverage ratio as a complementary measure to the risk-based capital requirements to limit excessive leverage on the part of banks. The Basel Committee's implementation timetable provides for a "parallel run" of the leverage ratio from 2013 until 2017, with the ratio becoming a binding requirement from 2018. The HKMA is developing a reporting template for all Hong Kong-incorporated AIs to submit their leverage ratio positions during the parallel run period. Basel III requires disclosure of the leverage ratio from 1 January 2015 and the HKMA will participate in the development of the relevant disclosure standard in the Basel Committee. Once it is binding, the Banking (Disclosure) Rules will be amended at the appropriate time to incorporate the new standard.

Liquidity standards

The Basel Committee issued a package of revisions to the liquidity coverage ratio (LCR) in January 2013 to address a variety of issues identified since the original publication of the LCR standard as part of the Basel III reform package. The major changes –

- *expand the range of assets eligible as high-quality liquid assets (HQLA) to include (subject to national discretion):*

  — non-financial corporate debt securities rated A+ to BBB-, subject to a 50% haircut;

  — listed common equity shares of non-financial corporates included in a main index, subject to a 50% haircut; and

Basel III (continued)

— certain high-quality residential mortgage-backed securities, subject to a 25% haircut

provided relevant qualifying criteria are met and the aggregate amount of such assets does not exceed 15% of a bank's total HQLA

- *reduce the outflow rates for certain retail and corporate deposits* to (i) 3% (from 5%) for certain insured retail deposits backed by a deposit insurance scheme that meets specified criteria; (ii) 40% (from 75%) for non-operational non-financial corporate deposits; and (iii) 20% (from 40%) for fully insured non-operational corporate deposits

- *reduce the drawdown rate for certain committed credit and liquidity facilities* to 40% (from 100%) for facilities extended to banks subject to prudential supervision

- *adopt a more granular treatment for derivatives risks* to ensure the LCR adequately captures the liquidity risk inherent in collateral substitution, the holding of excess collateral and customer short positions in client servicing brokerage

- *reduce the outflow rate for repos with central banks* to 0% (from 25%) to equalise the treatment with that for funding obtained from central banks via outright sale of assets.

The text regarding banks' ability to use their HQLA in times of stress has also been clarified. Furthermore, a phase-in arrangement has been introduced so that the minimum LCR requirement will begin at 60% on 1 January 2015 and then rise by 10 percentage points a year to reach 100% on 1 January 2019.

The HKMA is reviewing its strategy for implementing the LCR in light of these changes and will consult the industry in the second quarter of 2013 on proposed methodologies for the calculation of the LCR, based on the Basel Committee's revised standard. The consultation will form the basis for a set of Banking (Liquidity) Rules which is expected to be tabled in LegCo in 2014. The HKMA will endeavour to finalise its proposed two-tiered approach to the implementation of the LCR and the terms of the minimum liquidity ratio (to be observed by AIs not made subject to the LCR) in the first half of 2013.

The HKMA will augment the existing liquidity reporting framework so that it can both support the Basel III liquidity standards and enable the HKMA to make better use of liquidity monitoring tools and metrics in the supervision and oversight of AIs' liquidity risk profiles and positions.

In developing liquidity rules and reporting frameworks, the HKMA will maintain its dialogue with the industry and take account of the implementation approaches adopted by major overseas regulators.

Recovery and resolution

As part of its package of policy measures to reduce the risk posed by systemically important financial institutions, the FSB issued the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes) in November 2011. All member jurisdictions of the FSB and G20 are expected to meet these new international standards to ensure that both public authorities and financial institutions will be better placed to respond effectively to shocks that threaten to undermine the financial soundness of individual financial institutions (or financial market infrastructures).

During 2012, the FSB co-ordinated a self-assessment by jurisdictions of how far their existing arrangements for contingency planning and dealing with distressed firms meet the new standards in the Key Attributes. This work confirmed that although the statutory and regulatory framework in Hong Kong was relatively well-developed before the global financial crisis, further strengthening is now needed to reflect the latest best practices for effective resolution regimes. The HKMA is working with the FSTB and other regulators to develop the necessary enhancements and will engage key stakeholders during 2013.

An important aspect of the Key Attributes is the requirement for robust and credible recovery and resolution planning, at a minimum, for all global systemically important financial institutions (G-SIFIs) and for any other firm that its home authority assesses could have an impact on financial stability. The HKMA participates in the crisis management groups of a number of globally systemically important banks (G-SIBs) where work is underway to develop firm-specific group-level recovery and resolution plans. In addition, the HKMA has begun consulting the industry on policy proposals for local recovery and resolution planning requirements covering:

- key elements to be included in recovery plans prepared by AIs, such as governance, trigger events, stress scenarios, recovery options, implementation and communication plans

- a "top-down" and iterative approach to resolution planning beginning with a resolution strategy based on core information and analysis of key components of AIs' structures and operations, such as the critical functions performed by the AI or its corporate group; significant legal entities within the AI's corporate group; the AI's business lines and operating models; and dependencies between the AI and other members of its group and third parties. The resolution strategy can then be further developed into an operational plan

- a proportionate application across AIs, focused on ensuring initially that recovery and resolution planning is undertaken for AIs considered to be the most systemically significant or critical to the functioning of the Hong Kong banking sector.

Development of supervisory policies

Credit risk transfer

The HKMA is developing a supervisory guideline on credit risk transfer to reflect recent international developments in securitisation regulation (such as disclosure and alignment of incentives between originators and investors) and the reduction of reliance on ratings produced by credit rating agencies (such as more stringent requirements in respect of banks' internal credit assessment of securitisation exposures).

Market risk management

The HKMA intends to issue a new supervisory guideline on market risk management taking into account the lessons of the global financial crisis and observed best practices. Consultation with the industry associations is expected in the second quarter of 2013.

Guideline on over-the-counter derivatives market reforms

Once the margining standards for non-centrally cleared derivatives are agreed internationally, the HKMA will update its prudential framework in line with the new standards. After the over-the-counter (OTC) derivatives market regulatory regime is introduced in Hong Kong, the HKMA will issue supervisory guidance outlining the key requirements and its approach to supervising the OTC derivatives activities of authorized institutions (AIs).

Internal audit function

The supervisory guideline "Internal Audit Function" of AIs will be updated to reflect latest guidance in *The Internal Audit Function in Banks* issued by the Basel Committee on Banking Supervision in June, particularly in relation to the approach to internal audit across banks within a banking group or holding company structure and the communication between supervisory authorities and banks' internal auditors.

Management of risks associated with settlement of foreign exchange transactions

The Basel Committee issued updated *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* in February 2013, reflecting lessons from the global financial crisis. The HKMA's supervisory guidance on foreign exchange risk management will be revised accordingly.

Financial Sector Assessment Program

The International Monetary Fund (IMF) will lead a Financial Sector Assessment Program (FSAP) for Hong Kong in 2013. The IMF and the World Bank established the FSAP in 1999 as a comprehensive in-depth analysis of a country's financial sector. The last FSAP for Hong Kong was conducted in 2003. The two main components of the FSAP will be a macro-financial stress test of the banking system and a detailed assessment of the compliance of Hong Kong's banking regulations with the Basel Committee's *Core Principles for Effective Banking Supervision*, which were substantially revised in 2012. The FSAP for 2013 will also cover, among other things, financial safety-net arrangements, of which the DPS is a key part. The HKMA will work with the FSAP review team to facilitate their assessment. Any recommendations arising from the review will be followed up.

Accounting and disclosure standards

The HKMA will continue to monitor developments in international accounting convergence, particularly in the area of loan loss provisioning, and will maintain its regular dialogue with the HKICPA and the banking industry on these developments and their implications for the supervisory framework.

International co-operation

The HKMA will continue its involvement in the work of the Basel Committee and the FSB, including through the thematic peer review on the implementation of the FSB *Principles for Reducing Reliance on Credit Rating Agency Ratings* being conducted by the FSB in 2013.

Consumer protection

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

The HKMA will enhance its efforts on banking consumer education. Initiatives will be launched to improve product knowledge and consumers' understanding of their rights and obligations. The HKMA will also continue to have an active role in the work of the IEC and co-operate with it on investor education initiatives.

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 and work with the industry to promote credit data sharing. Continued development of the credit data sharing arrangements will help strengthen the credit risk management capacity of AIs.

Enforcement

The HKMA will expedite the handling of outstanding complaint cases not related to Lehman Brothers, the progress of which has been affected by the need to accord priority to Lehman Brothers-related complaints in the past few years. Without materially affecting the timely handling of new complaints, the HKMA aims to clear the bulk of this backlog in 2013.

Priority will also be given in 2013 to the handling of cases under the new enforcement regimes relating to anti-money laundering and MPF intermediaries, to uphold industry standards.

The HKMA will continue its co-operation with other financial regulators through enhancing working contacts, participating in inter-regulator working groups such as the Anti-Money Laundering Regulatory Enforcement Co-ordination Group and organising experience-sharing sessions with other financial regulators upon request.

Deposit protection

The HKMA will continue to assist the HKDPB in implementing and operating the DPS. As the external environment is expected to remain volatile, it is important for the HKDPB to maintain its readiness to execute a payout effectively. Efforts will be made to further enhance payout efficiency, including tightening the timing and format of depositor information to be submitted by a Scheme member in the event of a bank failure, as well as refinements to the payout policies and procedures to shorten the time required to calculate and disburse compensation payments. The banking industry and other relevant parties will be consulted on the proposals.

Self-assessment and on-site examinations will be conducted to monitor Scheme members' compliance with the representation requirements on DPS membership and protection status of financial products. Riding on the encouraging improvement in public awareness of the DPS, new educational and outreach initiatives will be undertaken for specific target groups such as senior citizens and youth.

Payment systems oversight

As overseer of designated systems under the CSSO, the HKMA will continue to promote and ensure the safety and efficiency of these systems, monitor the performance of the operators of retail payment systems under their self-regulatory codes of practice, and develop the current regime based on the new international standards.

The HKMA will work with the system operators and settlement institutions of the designated systems to achieve observance of the *Principles for Financial Market Infrastructures* (PFMIs). The local designated systems will be required to conduct self-assessments against the PFMIs based on the related disclosure framework and assessment methodology for FMIs. The HKMA will also be involved in external assessments of Hong Kong's observance of the PFMIs, including the FSAP review.

A regime for overseeing the trade repository, a central registry for collecting and maintaining records of over-the-counter derivatives transactions, will be formulated by the HKMA and incorporate the requirements under the PFMIs.

Licensing

The revised supervisory guideline "Corporate Governance of Locally Incorporated Authorized Institutions", issued in August 2012, sets out the HKMA's expectations in relation to induction training and continuing development to be provided to directors of AIs. The HKMA conducted a survey on training for directors of locally incorporated AIs in September 2012, to gather information on how the AIs assess the training needs of directors and the training currently being provided. The information collected will enable the HKMA to identify whether there are any gaps in the availability of training resources, and whether a degree of co-ordination in the provision of such training will be beneficial.

The HKMA will consider measures to help further enhance the development of directors. In the meantime, all locally incorporated AIs are encouraged to identify gaps and take steps to bring their practices in relation to board development in line with the HKMA's guidance.

International Financial Centre

The global economy showed signs of stabilisation towards the end of 2012, but the recovery remained fragile and uneven. To help promote stability and resilience of the global financial system, the HKMA participated proactively in international and regional forums to discuss ways to strengthen market surveillance and co-ordinate implementation of the global financial regulatory reforms. Renminbi business continued to expand, strengthening Hong Kong's position as the premier offshore renminbi business centre. Hong Kong's strong credit standing and robust fiscal performance was reaffirmed by credit rating agencies — Standard & Poor's maintained its AAA rating and Moody's remained positive to the credit outlook for Hong Kong.

OVERVIEW

The global economy and financial markets experienced a volatile session in the first half of 2012 as heightened concerns regarding the European sovereign debt crisis and deterioration in growth prospects weighed heavily on market sentiment. Following a series of accommodative measures introduced by policymakers around the world, some signs of stabilisation emerged near the end of the year. Nevertheless, the outlook remains highly uncertain. In Asia, while many economies demonstrated resilience during this period, trade and financial sectors were affected. Closer international and regional co-operation is needed to promote greater financial stability and to achieve a more robust global economic recovery.

The HKMA proactively participates in international discussions and exchanges views with the international community on issues of significance to global and regional financial stability. In 2012, it assumed chairmanship of the Monetary and Financial Stability Committee established under the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).[1] The Committee is EMEAP's main platform for reviewing economic and financial developments in the Asia-Pacific region, identifying areas of vulnerability and policy options. The HKMA also took part in meetings and forums of multilateral organisations, notably the Financial Stability Board (FSB)[2], which plays the leading role in the reform of the international financial system. In addition, the HKMA continued to work closely with ASEAN+3[3] authorities on implementation work relating to enhancing the Chiang Mai Initiative Multilateralisation (CMIM), including the doubling of its access fund[4] and strengthening the operations of the ASEAN+3 Macroeconomic Research Office – an independent regional surveillance unit to monitor and analyse regional economies and support CMIM decision making.

The development of Hong Kong as the premier offshore renminbi business centre progressed significantly in 2012, with notable growth in renminbi trade settlement, financing and wealth management activities, and its expanding links with the Mainland and internationally. These developments have entrenched Hong Kong's role as a global hub for a wide range of offshore renminbi financial activities.

In addition, on 25 June the operating hours of the renminbi Real Time Gross Settlement (RTGS) system was extended to 15 hours, serving from 8:30 a.m. to 11:30 p.m. This gives financial institutions in other parts of the world, particularly those in the European time zone and early North American business hours an extended window to settle offshore renminbi payments through the Hong Kong infrastructure. Indeed, the safe and efficient operation and the continued development of the financial infrastructure in Hong Kong plays a significant role in reinforcing its competitive edge as an international financial centre. During the year, the different components of the financial infrastructure operated smoothly. In other developments, the first phase of the local over-the-counter (OTC) derivatives trade repository for supporting voluntary central clearing of OTC derivatives transactions was launched in December.

1 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.

2 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 promote implementation of 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.

3 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.

4 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. In May 2012, enhancements to the CMIM included a doubling of its access fund to US$240 billion and the introduction of a crisis prevention facility.

International Financial Centre

REVIEW OF 2012

International and regional co-operation

To advance international and regional co-operation in economic and financial surveillance, as well as enhance policy co-ordination, the HKMA participated proactively in important discussions under the auspices of the FSB, the Bank for International Settlements (BIS), and the Asia-Pacific Economic Co-operation on issues of common interest including bolstering financial resilience and promoting sustainable economic growth. Through its participation in the FSB and various international standard-setting bodies, the HKMA also continued to advocate the implementation of global financial regulatory reforms, in particular the recommendations of the Group of Twenty (G20). Further information on the HKMA's role in international regulatory co-operation can be found in the Chapter on Banking Stability.

The HKMA hosted two high-level international meetings in Hong Kong in 2012. In February, an informal meeting of central bank governors and a back-to-back meeting with CEOs of key financial institutions was co-hosted with the BIS. Governors and senior officials from 22 central banks and 18 CEOs of financial institutions around the world attended the meetings. They provided an opportunity for the central bank governors to review the global economic and financial developments, with a specific focus on Asia, and to exchange views with the private sector. The HKMA also hosted the FSB Plenary Meeting in May, which was attended by some 70 heads and senior representatives of central banks, supervisory authorities, finance ministries, international financial institutions and standard-setting bodies. The delegates discussed the risks facing the world economy, and reviewed progress on global financial regulatory reforms.

Representing the Government of the Hong Kong Special Administrative Region, the HKMA took part in negotiations on the tenth replenishment of the Asian Development Fund, a concessional financing facility of the Asian Development Bank for the region's poorest economies. Funding approval will be sought from the Finance Committee of the Legislative Council (LegCo) for Hong Kong's contribution to the replenishment in early 2013.

Promoting monetary and financial stability in Asia

The HKMA participated proactively in regional co-operative initiatives to promote monetary and financial stability in Asia and to improve the region's collective voice in international financial affairs. In 2012, as Chair of the EMEAP Monetary and Financial Stability Committee, the HKMA led the Committee's discussion on issues of common interest, particularly the implications of the global financial regulatory reforms for the region, and facilitated the formation of a collective voice for EMEAP members to contribute to the international discussions. The HKMA also continued to conduct analyses and prepare the Committee's half-yearly Macro-Monitoring Report to assess the region's risks and vulnerabilities and policy implications.

The HKMA continued to work closely with ASEAN+3 authorities on enhancements to the CMIM. The organisational capacity of the ASEAN+3 Macroeconomic Research Office was also strengthened to improve its ability to monitor the macroeconomic and financial soundness of regional economies and to facilitate effective decision-making of CMIM participants under the enhanced CMIM.

The HKMA's role as a deputy chair of the EMEAP Working Group on Payment and Settlement Systems continued for another term after the completion of its two-year term. It has been working closely with the People's Bank of China (PBoC) and Bangko Sentral ng Pilipinas (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 the sub-group on cross-border co-operation and development.

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

Hong Kong's sovereign credit ratings

The HKMA continued its dialogue with 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 2012. In particular, Standard & Poor's affirmed its highest rating of AAA for Hong Kong, reflecting the agency's recognition of Hong Kong's above-average growth prospects, strong external position, sizable fiscal reserves, and consistently robust fiscal performance. Moody's Investors Service and Fitch Ratings also 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 breadth and depth of the offshore renminbi market in Hong Kong and its links with the Mainland and other parts of the world expanded considerably in 2012. Adding to this was the announcement by the Central Government in June of a series of additional measures to bolster Hong Kong as the offshore renminbi business centre, including further issuance of renminbi bonds in Hong Kong by the Ministry of Finance and by Mainland banks and enterprises; support for the use of the Hong Kong platform by parties from other places to settle trade and investment transactions in renminbi; and relaxation of the investment quotas, the range of participating entities and the investment restrictions of the Renminbi Qualified Foreign Institutional Investors (RQFII) scheme. These measures help consolidate Hong Kong's status as a global centre for offshore renminbi trade settlement, financing and asset management.

In another development, a set of provisional administrative rules for renminbi cross-border bank lending for Qianhai was released in December by the Shenzhen authorities, which enabled companies incorporated in Qianhai to borrow renminbi loans from banks in Hong Kong for uses relating to the development of Qianhai. This arrangement provides more business opportunities for the development of renminbi banking services in Hong Kong.

Renminbi trade settlement handled by banks in Hong Kong in 2012 amounted to RMB2,632.5 billion, a year-on-year increase of 37%. Together with the overall expansion of the scale and scope of renminbi banking activities, Hong Kong banks in August started to provide renminbi services to personal customers who are non-Hong Kong residents. At the end of 2012, some 29,000 accounts were opened by non-resident personal customers, with deposits exceeding RMB4 billion.

Renminbi financing activities were also vibrant. At the end of the year, the outstanding renminbi bonds issued in Hong Kong was RMB237.2 billion, up 60% from a year ago. Renminbi lending by banks in Hong Kong also expanded, with outstanding renminbi loans amounting to RMB79.0 billion, more than double the amount in 2011. At the same time, the range of renminbi financial instruments and products grew to include renminbi shares, currency futures and exchange-traded funds accessing the A-share market. All these activities were supported by a sustained pool of liquidity, with renminbi customer deposits and outstanding certificates of deposit issued by banks totalling RMB720.2 billion at the end of 2012, an increase of 9% from a year earlier.

As a global hub for offshore renminbi business, Hong Kong is playing an increasingly important role in supporting international corporations and financial institutions in conducting offshore renminbi business. At the end of 2012, 204 banks were participating in Hong Kong's renminbi clearing platform, of which 181 were subsidiaries and branches of overseas banks and the overseas presence of Mainland banks. Some 1,400 correspondent banking accounts were maintained by overseas banks with banks in Hong Kong, compared with 900 a year ago. The average daily turnover of Hong Kong's renminbi RTGS system reached RMB264 billion in December 2012 with 90% of the transactions conducted in the offshore renminbi market. To support the continued deepening of the renminbi capital market in Hong Kong and to reinforce Hong Kong's role as the global hub for offshore renminbi business, the HKMA introduced a facility in June to provide renminbi liquidity to authorized institutions participating in renminbi business in Hong Kong.

International Financial Centre

As part of its efforts to promote the international use of Hong Kong's renminbi platform, the HKMA organised various seminars and meetings in Hong Kong, and conducted roadshows in Brazil, Chile and Japan. In January 2012, the UK Chancellor of the Exchequer, Rt. Hon. George Osborne, and the Chief Executive of the HKMA, Mr Norman Chan, announced the establishment of a private sector-led Hong Kong-London Forum to promote closer collaboration between the two cities to support the wider international use of renminbi. The Forum convened two meetings during the year, which resulted in the participating banks achieving notable progress in enhancing market liquidity, payment and settlement arrangements and products and services. Meanwhile, a renminbi Trade and Investment Dialogue between Hong Kong and Australia was launched in July, and its first meeting will be held in Sydney in 2013.

Chief Executive of the HKMA, Mr Norman Chan (third from right) in a panel discussion at the "Hong Kong: Offshore Renminbi Centre for Global Businesses" seminar in Tokyo.

Chief Executive of the HKMA, Mr Norman Chan, addresses a seminar in Sao Paulo, Brazil, to promote Hong Kong as the offshore renminbi business centre.

CEPA

The Ninth Supplement to the Closer Economic Partnership Arrangement (CEPA) was signed in June. There are two new measures for the banking sector – the first allows eligible Mainland subsidiaries of Hong Kong banks to offer custodian services regarding settlement funds of customers of securities companies and margin deposits on futures transactions; the second allows Hong Kong financial institutions to set up consumer finance companies in Guangdong Province on a pilot basis.

Training

Training programmes are conducted in Hong Kong and the Mainland for officials of the PBoC, the State Administration of Foreign Exchange and the China Banking Regulatory Commission (CBRC). During the year, 933 officials from the Mainland attended 13 courses (2,276 man-days) covering the credit information system; financial market development and supervision; internal control and supervision; macroeconomics and financial analysis; corporate governance and external relations of the HKMA; financial markets and services; and banking supervision. The HKMA also provided training on request to other external parties, including delegations from branch offices of the CBRC, the Korea Financial Supervisory Service and a local university. A total of 123 participants attended these seminars in 2012.

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 $16 billion, with tenors ranging from two to 10 years, were completed in 2012. The amount of institutional bonds outstanding at the end of the year was $47 billion. The HKMA will maintain close contact with market participants and consider relevant measures to refine the institutional part.

For the retail part, a further issuance of the $10 billion inflation-linked retail bond (i.e. the second iBond) was announced in the Government's 2012-13 Budget. The issuance was arranged by the HKMA with assistance from relevant service providers. The second iBond was offered to Hong Kong residents in June and attracted over 330,000 applications, with application monies approaching $50 billion. Both the number and amount of valid applications set records in the local retail bond market. The $10 billion iBond was issued on 22 June.

Development of Islamic finance

The HKMA assisted the Government in the preparation of a legislative proposal to amend Hong Kong's tax laws to provide a tax regime for common types of Islamic bonds (sukuk) that is comparable with the one applying to conventional bonds. In particular, the HKMA helped conduct a two-month public consultation beginning in March. The purpose of the consultation was to ensure the legislative proposal, especially the parts concerning the features and structures of sukuk and the proposed tax treatment, would be practicable and meet market needs. The responses received from a broad range of interested stakeholders were largely receptive to the proposal. Many useful suggestions and comments were taken into account in finalising the amendment bill. The relevant consultation conclusions were issued in October.

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, continues to explore ways to improve the international competitiveness of Hong Kong's financial markets and provide a more favourable tax and regulatory environment for such businesses. The HKMA took part in joint promotional roadshows to New York, Geneva, Lugano and Zurich to highlight the strength of Hong Kong's financial platform, focusing on its advantages as an offshore renminbi centre and premier asset management hub.

The HKMA also visited asset managers in major financial centres through small groups and one-on-one meetings to highlight the latest developments in Hong Kong and listen to their business plans for Asia. In seeking their views on potential hurdles for their operations in Hong Kong, the HKMA can help improve Hong Kong's financial platform. These outreach meetings were held with private banking institutions, pension funds, mutual funds, private equity firms, hedge funds and fund administrators in Abu Dhabi, Beijing, Dubai, Dublin, Geneva, Frankfurt, Korea, London, Lugano, Montreal, New York, Paris, San Francisco, Shenzhen, Singapore, Toronto 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, aimed at reducing systemic risk and enhancing transparency in the OTC derivatives market.

Following public consultation on the proposed regulatory regime for the OTC derivatives market in October 2011, the HKMA and the SFC jointly published in July 2012 the consultation conclusions in response to the comments received. At the same time a supplemental consultation paper was issued on the proposed scope of the new and expanded regulated activities and the oversight of systemically important players. Taking into account the responses from the two consultations, the HKMA and the SFC have been working on the legislation needed to provide for the regulatory framework for Hong Kong.

The HKMA continued to engage the industry through a number of channels, including the OTC Derivatives Market Working Group under the Treasury Markets Association (TMA) and its sub-groups, which address specific regulatory and infrastructural issues. The HKMA also participated in international forums, including the OTC Derivatives Working Group, established under the FSB, the OTC Derivatives Regulators' Forum, and Basel Committee and the International Organization of Securities Commissions (IOSCO) joint Working Group on Margining Requirements, contributing to the relevant international initiatives and monitoring closely the international regulatory developments.

Cross-border co-ordination on OTC derivatives market reform

In early July, the US Commodity Futures Trading Commission (CFTC) issued proposed interpretive guidance on the cross-border application of certain provisions of the Commodity Exchange Act relating to swaps. In certain circumstances this requires non-US persons engaged in swap dealing with US persons to register with the CFTC and meet specified entity-level and transaction-level requirements. The HKMA and the SFC wrote jointly with other regional regulators (the Australian Securities and Investments Commission, Reserve Bank of Australia and Monetary Authority of Singapore) to the CFTC raising concerns about the extra-territorial implications of the proposed guidance for non-US financial institutions and non-US financial markets. The issues are being followed up through both bilateral and multilateral discussions between the CFTC and other regulators, including Hong Kong.

Treasury Markets Association

The HKMA continued to work in collaboration with the TMA to develop Hong Kong's treasury markets, 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.

At the end of 2012, the Association had 1,690 Individual Members and 80 Institutional Members from banks, investment houses, insurance companies, money brokers, financial information services providers, exchanges and large corporations. During the year, the TMA accomplished several important tasks:

- **conducted a review into HIBOR fixing** – commissioned by the Hong Kong Association of Banks (HKAB), the TMA reviewed the fixing mechanism and governance arrangements for the Hong Kong dollar Interest Settlement Rates, more commonly known as HIBOR fixing, to identify any room for improvement.

- **conducted a study into Hong Kong's business environment for corporate treasury units** – the study has identified a few impediments in Hong Kong's tax regime and in cross-border fund flows between Hong Kong and the Mainland for corporate treasury units, and has made a number of recommendations to address them. The findings will be submitted to the relevant authorities for consideration.

- **displaying CNY(HK) interbank offered rates on the TMA website** – selected banks in Hong Kong started displaying their CNY(HK) interbank offered rates on the TMA website in 2012, in a bid to enhance transparency and assist in the development of renminbi products in Hong Kong before the emergence of a formal CNY(HK) HIBOR fixing in Hong Kong.

- **co-organising the Treasury Markets Summit with the HKMA** – the Summit was held in October with emphasis on the development of Hong Kong as an offshore renminbi centre, trends in Hong Kong's asset management business and ways to maintain professionalism and ethical standards in Hong Kong's treasury markets.

International Financial Centre

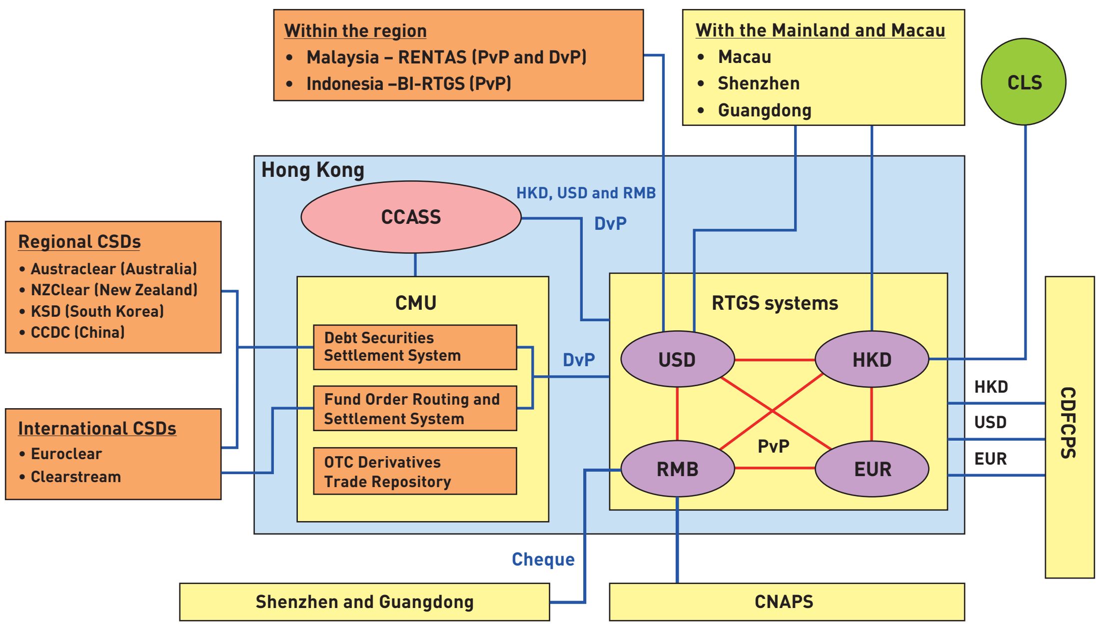
Hong Kong's financial infrastructure

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

In response to industry demands and international developments, new components have been added to broaden the scope and increase the depth of the financial infrastructure in Hong Kong. For example, an order routing and settlement system for investment funds was introduced in 2009, a trade repository for OTC derivatives was introduced in 2012 and retail payment infrastructure will be introduced in 2013-14.

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 HKAB. In 2012, the HKICL processed a daily average of $496 billion in CHATS transactions (23,010 items), compared with $539 billion (22,682 items) in 2011.

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 all operated smoothly. The average daily turnover of the renminbi RTGS system continued its brisk growth momentum in 2012 rising to RMB214 billion, after increasing from RMB5 billion in 2010 to RMB121 billion in 2011, amid the rapid expansion of renminbi business in Hong Kong. The momentum accelerated for the year and the daily average reached RMB264 billion in December. 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

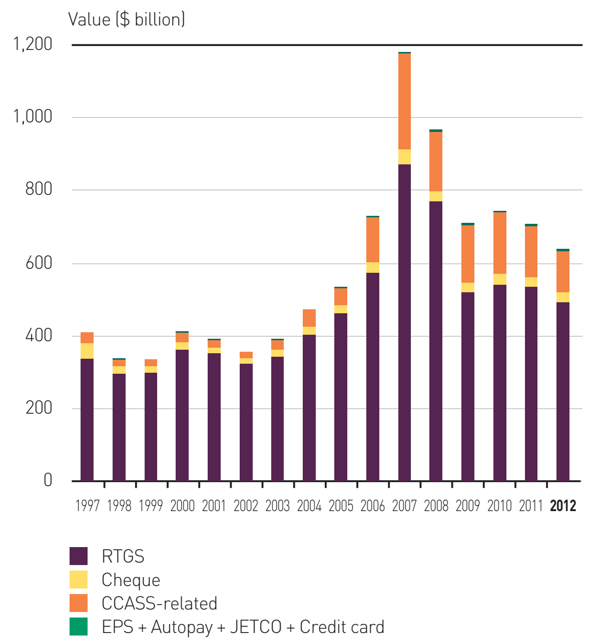


Chart 3 US dollar RTGS system average daily turnover

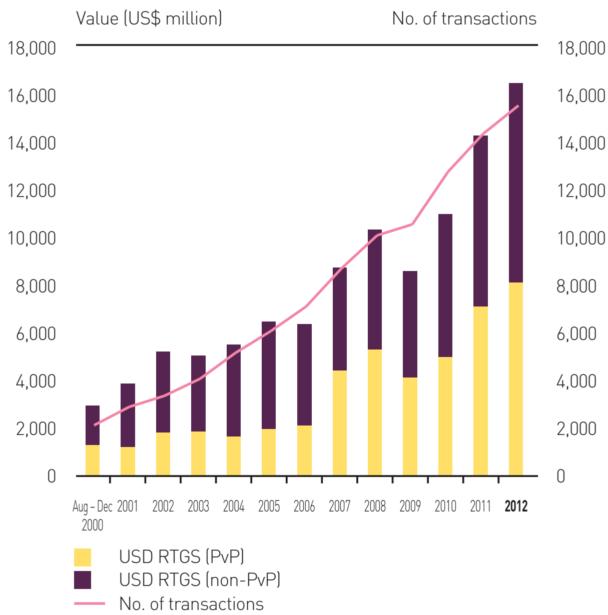


Chart 4 Euro RTGS system average daily turnover

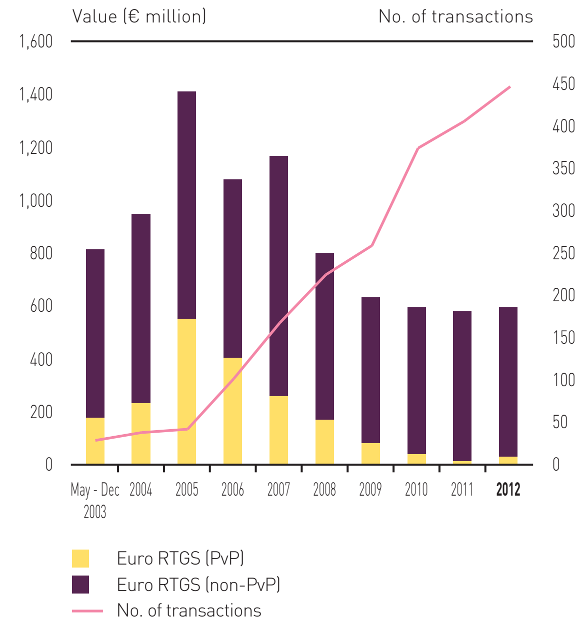


Chart 5 Renminbi RTGS system average daily turnover

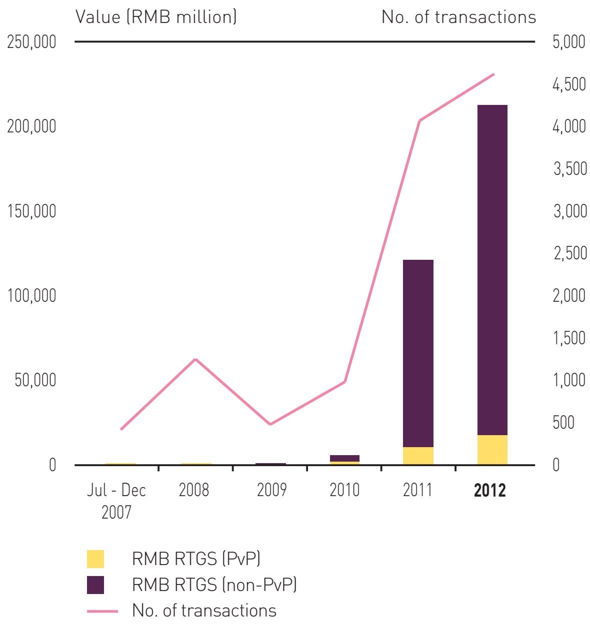


Table 1 Foreign currency RTGS systems

RTGS system	Launch date	Settlement institution or Clearing Bank	Number of participants at the end of 2012	Average daily turnover in 2012	Average daily transactions in 2012
US dollar	August 2000	The Hongkong and Shanghai Banking Corporation Limited	Direct: 92 Indirect: 130	US$16.4 billion	15,404
Euro	April 2003	Standard Chartered Bank (Hong Kong) Limited	Direct: 33 Indirect: 19	€581.8 million	432
Renminbi	June 2007	Bank of China (Hong Kong) Limited	Direct: 174*	RMB213.7 billion	4,600

* Refers to those that have completed the registration of direct membership for the renminbi RTGS system among over 200 participating banks that have signed the Clearing Agreement with the Clearing Bank.

Payment-versus-payment

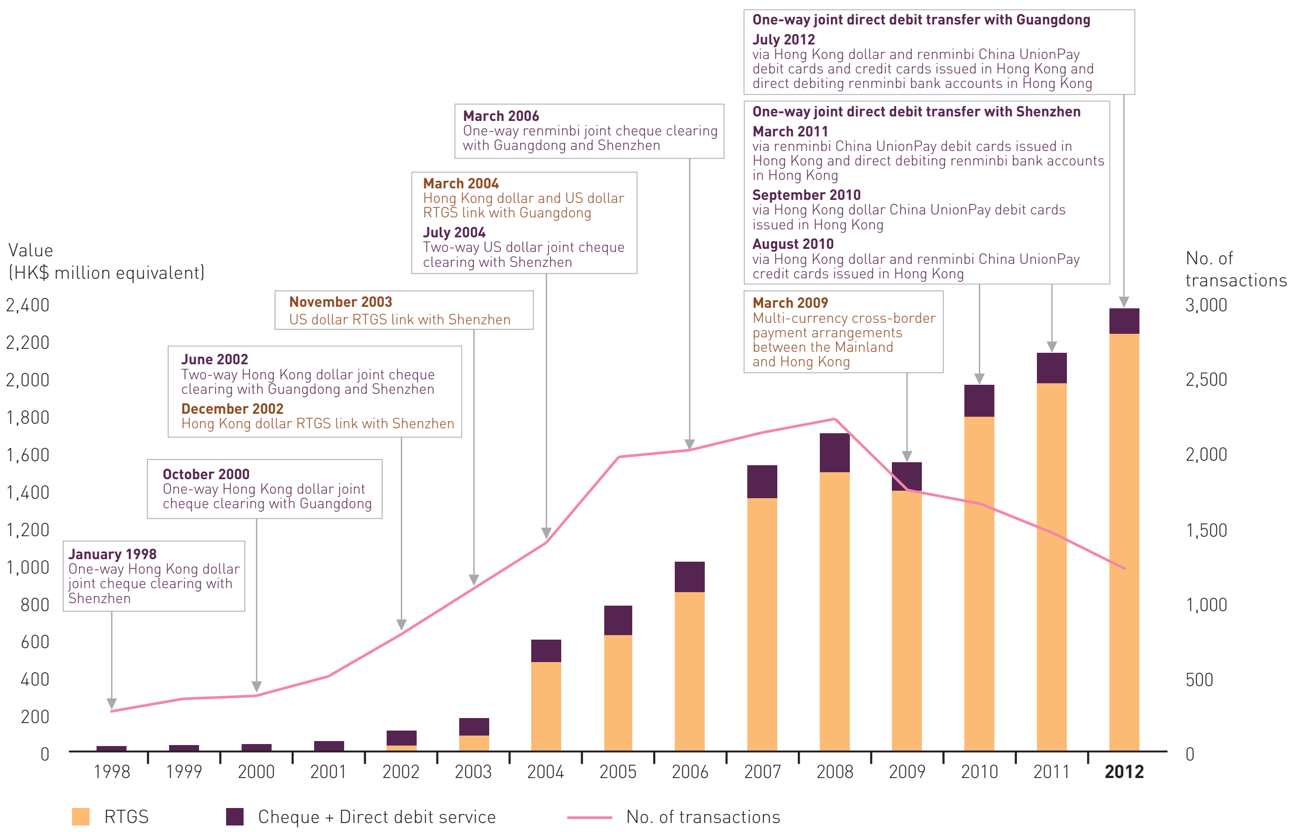
Payment-versus-payment (PvP) is a mechanism for settling a foreign exchange transaction to ensure that payments in the two currencies involved are settled simultaneously. Within Hong Kong, six cross-currency PvP links have been established among the Hong Kong dollar, US dollar, euro and renminbi RTGS 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 2012, the transaction value of Hong Kong dollar, US dollar, euro and renminbi-related PvP transactions amounted to about HK$4,283 billion, US$1,992 billion, €8 billion and RMB3,996 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 2012, the average daily turnover handled by the various system links was equivalent to $2.4 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 23,500 transactions during the year, with a total value equivalent to $523 billion. The system allows cross-border payments in Hong Kong dollars and US dollars 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 262,000 Hong Kong dollar and US dollar cheques in 2012, with a value equivalent to $31 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 2012, renminbi cheques with a total value equivalent to around $35 million were cleared.

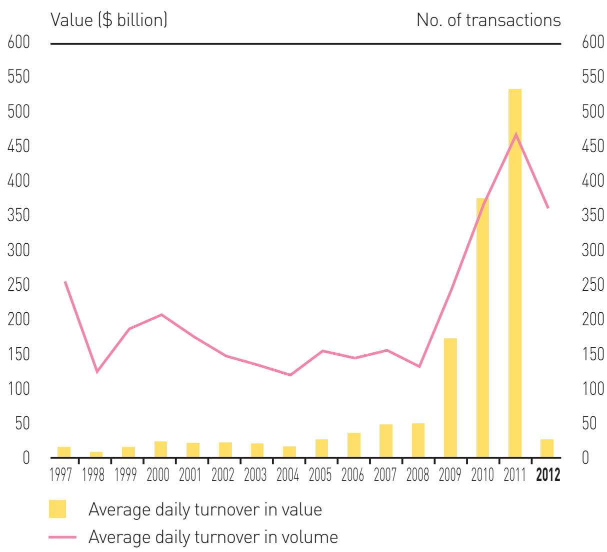
Payment links with Macau

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 2012, Hong Kong dollar cheques with a total value of about $29 billion and US dollar cheques with a total value of about US$26 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, investors outside Hong Kong can hold and settle securities lodged with the CMU. These linkages also assist Hong Kong investors to hold and settle foreign securities held with CSDs outside Hong Kong. In 2012, the CMU processed an average daily value of $26 billion (359 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 $657 billion and the total amount of other debt securities was equivalent to $885 billion, of which renminbi debt securities amounted to RMB314 billion.

Chart 7 CMU secondary market turnover



Financial infrastructure development

The HKMA completed a number of projects in 2012 to improve the safety and efficiency of Hong Kong's financial infrastructure, and to capture new business opportunities.

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

This cross-border joint direct debit transfer service was modelled on a similar service between Hong Kong and Shenzhen through the use of Hong Kong dollar and renminbi China UnionPay credit cards and debit cards issued in Hong Kong to make payments, or directly debiting renminbi accounts in Hong Kong. This service, which was launched on 16 July, provides Hong Kong residents with a more convenient payment channel for making regular and recurring cross-border small-value payments to merchants in Guangdong Province, such as payments of property management fees and utilities bills.

Introduction of multiple same day auto-credit settlement in the Hong Kong dollar and renminbi RTGS systems

The existing auto-credit clearing and settlement model was upgraded to enable three bulk settlement runs a day for auto-credit items in the Hong Kong dollar and renminbi RTGS systems. The improved service started on 17 September, as compared with the previous two bulk settlement runs in the Hong Kong dollar RTGS system and one in the renminbi RTGS system.

The change helps shorten the clearing and settlement cycle and enhance the settlement efficiency at the interbank level. Customers can also benefit if money received from these multiple runs can be credited to their accounts shortly after the runs. In response to industry demands to provide an even better auto-credit service to their customers, a refinement was introduced on 29 October, whereby the morning settlement run was advanced by over an hour to 8:45 a.m., thus facilitating banks to credit money to their customer's account very early in the day.

Cross-border collateral management service

The HKMA co-operated with Euroclear Bank and J.P. Morgan to start offering a cross-border collateral management service from 25 June. The new facility, the first add-on service following the March launch of the pilot platform for cross-border investment and settlement of debt securities, enables members of the HKMA's CMU to conduct triparty repo transactions with international financial institutions. It aims at developing and promoting a cost effective and efficient repo market in Hong Kong, thereby helping improve financial stability through the greater use of collateral to cover exposures in lending and borrowing. The service also opens an efficient channel for financial institutions to widen their liquidity sources and obtain offshore renminbi liquidity from Hong Kong.

CMU Central Bank Placement Co-ordinating Window

The HKMA's tendering platform service for the issuance of offshore renminbi sovereign bonds entered a new phase in June with the establishment of the CMU Central Bank Placement Co-ordinating Window. The new window further promotes the development of Hong Kong's renminbi bond market by expanding the investor base to include central banks and monetary authorities.

On 28 June, the Ministry of Finance became the first government authority to use the CMU Central Bank Placement Co-ordinating Window for an RMB2 billion placement. It attracted a total subscription of RMB3.06 billion from overseas central banks and monetary authorities. In addition, RMB15.5 billion in offshore renminbi sovereign bonds was issued to institutional investors through the HKMA's bond tendering platform of the CMU, and RMB5.5 billion was issued to retail investors.

The Co-ordinating Window, which can be developed to serve more overseas central banks or sovereign institutions, will help consolidate the role of Hong Kong as the global hub for offshore renminbi business.

Trade repository for OTC derivatives

The development of the local trade repository for OTC derivatives has been progressing on schedule. In December, the transaction matching and confirmation function of the trade repository was launched to support voluntary central clearing of OTC derivatives transactions at the central counterparty clearing facility of the Hong Kong Exchanges and Clearing Limited. Intensive preparations were also made for launching the trade repository's transaction reporting function. After taking into account evolving local and international regulatory and reporting standards, and industry comments, the HKMA refined and re-issued in December the technical specifications for the transaction reporting function and the relevant service reference manual. Industry-wide briefings were also held to assist industry participants to have their systems ready for the implementation of the mandatory reporting requirement under the regulatory regime targeted for 2013.

Retail payment initiatives

Throughout the year, the HKMA continued its effort to further improve Hong Kong's retail payment infrastructure. The initiatives and their progress are summarised below.

Launch of two-in-one cards

The two-in-one card initiatives between Octopus Cards Limited (OCL) and Guangdong Lingnan Pass Company Limited (LNP) and between OCL and Shenzhentong Company Limited (SZT) were successfully launched in July and September respectively. The OCL/LNP co-brand card can be used for public transport and certain retail outlets in Hong Kong as well as 17 cities in Guangdong Province, while the OCL/SZT co-brand card covers public transport and certain retail outlets in Hong Kong and Shenzhen. Both initiatives have the full support of the HKMA and other authorities in Mainland China.

Implementation of electronic bill presentment and payment system

Scheduled for launch in the second half of 2013, the electronic bill presentment and payment (e-bill) system will provide a consolidated platform for the straight-through processing of electronic bill presentments and payments. It is a multi-currency multi-functional platform that supports Hong Kong dollar, renminbi and US dollar bill payments and handles a range of transactions including:

(i) business-to-customer (B-2-C) e-billing and e-payment;

(ii) business-to-business (B-2-B) e-billing and e-payment;

(iii) cross-border e-billing and e-payment; and

(iv) online charity payments and presentment of electronic donation receipts.

At the end of December 2012, more than 20 banks, which cover nearly all retail banks providing Internet banking services in Hong Kong, have confirmed to join the platform. Major billers including the Hong Kong Government and certain utility companies have already indicated interest in using the services through the participating banks.

Development of e-cheques

The HKMA has worked with the industry to develop an operating model of an e-cheque that can be signed, issued, delivered and presented through electronic means. Initial industry consultation on the proposed operating model has so far been supportive as e-cheques will help reduce resources for processing, save the need for physical delivery and presentment at bank branches, enhance the efficiency of cheque processing and provide better security features. The HKMA aims to commence system development in early 2013 and, subject to the results of industry-wide testing, expects the service to be available to the market near the end of 2014 or the beginning of 2015.

Near Field Communication[5] mobile payment

In view of the growing acceptance of mobile payment services and the availability of NFC-enabled mobile phones both locally and globally, the HKMA appointed a consultancy firm in July to conduct a study and recommend a strategy for developing an interoperable NFC mobile payment infrastructure in Hong Kong. The study covered the worldwide NFC deployment trends, collected feedback from local stakeholders and recommended options for implementing such a platform in Hong Kong. The infrastructure needs to achieve three main objectives: the NFC mobile payment services should not depend on a particular brand of mobile phone; customers can download all available payment services onto one mobile phone; and, customers are able to continue using the mobile payment services despite changing from one mobile network operator to another. The HKMA aims to complete the consultancy study in the first quarter of 2013.

New regulatory regime for Stored Value Facilities and Retail Payment Systems

Technological advancements and increasing acceptance of new technologies by the public have led to the emergence of innovative retail payment products and services globally. While Hong Kong's current regulatory framework for multipurpose stored value cards under the Banking Ordinance has so far been effective, it may not be wide enough to cover emerging and innovative retail payment products and services. As well, the failure of unregulated products and services may adversely affect public confidence in payment systems which, in turn, may undermine the stability and effective working of the financial system in Hong Kong.

Against this backdrop, the HKMA began preparatory work on legislative amendments to implement a new regulatory regime for stored value facilities and retail payment systems in Hong Kong. The goals are to protect users from possible services failure and to ensure the safety and soundness of the operation of such services; to foster competition and innovation in the market; and to further enhance Hong Kong's status as an international financial centre. Initial consultation with major industry participants on the regulatory proposals was completed during the year, followed by the release of a formal industry consultation paper at the end of the year to solicit comments on the proposed framework. These will be used in the development of the legislative amendments.

Pan-Asian CSD Alliance project

The HKMA, Bank Negara Malaysia and Euroclear Bank jointly launched a pilot platform for cross-border investment and settlement of debt securities in March. The platform offers a wide range of services, including a global securities database, provision of a single point of entry for investors to buy and hold international and domestic bonds through their accounts of the local system, and cross-border issuance and settlement of bonds in foreign currencies on a delivery-versus-payment (DvP) basis.

[5] Near Field Communication (NFC) is a short-range wireless connectivity technology that provides intuitive, simple, and safe communication between electronic devices. Communication occurs when two NFC-compatible devices are brought within four centimetres of one another.

PLANS FOR 2013 AND BEYOND

The HKMA will continue to co-operate with other agencies and the private sector locally and internationally to implement initiatives that improve Hong Kong's competitiveness as an international financial centre.

International and regional co-operation

Despite recent improvements in market sentiment, the outlook for the global economy in 2013 remains highly uncertain, as a number of advanced economies continue to deal with debt problems. Cross-border capital flows are likely to remain volatile in an environment of excessive global liquidity and constant shifts in market sentiment. Meanwhile, many of the global financial regulatory reforms are now entering the implementation phase and require cross-border co-ordination. All these call for closer international and regional co-operation to improve surveillance and policy co-ordination. The HKMA will continue its proactive participation in various central banking and international financial forums to contribute to the global effort. As the Chair of the EMEAP Monetary and Financial Stability Committee, the HKMA will work closely with other regional central banks to continue to spearhead the macro-surveillance work and promote the region's collective voice in international financial affairs.

Hong Kong's sovereign credit ratings

The HKMA will strive to preserve Standard & Poor's AAA rating for Hong Kong, and pursue further upgrades of ratings by Moody's, Fitch and other major international credit rating agencies.

Development of Hong Kong as the premier offshore renminbi business centre

The continued strengthening of renminbi business links with the Mainland and other parts of the world will be essential for the further development of Hong Kong as the premier offshore renminbi business centre. As such, the HKMA will continue its outreach initiatives to further expand Hong Kong's offshore renminbi services to the international community, and promote collaborations with other places in respect of the development of renminbi business.

The HKMA will also engage the Mainland authorities in promoting two-way flows and efficient intermediation of renminbi funds between the onshore and offshore markets, as well as expanding CEPA and other financial co-operation initiatives.

Market development

The HKMA will continue to participate in developing the local debt market, and in implementing the Government Bond Programme to broaden its investor base and enhance its liquidity. It will maintain close dialogue with the private sector and industry associations to expand the range and sophistication of market products and services.

The development of stock market in Hong Kong will move a step closer with the Government's amendment bill expected to be tabled in LegCo in early 2013. The HKMA will continue to work with the FSTB and other relevant parties to take forward this initiative. And, it will continue to work with other agencies to explore ways to further enhance the competitiveness of Hong Kong's financial sector, particularly in the promotion of Hong Kong as an international asset management hub. The HKMA will also continue to reach out to the asset managers in major financial centres, promoting Hong Kong as an offshore renminbi centre and an international asset management hub.

OTC derivatives market regulation

The HKMA will continue to work with the FSTB and the SFC towards developing the regulatory regime for the OTC derivatives market in Hong Kong. It is planned to introduce the relevant Bill into LegCo in the first half of 2013. The HKMA and the SFC also plan to conduct a public consultation on the detailed rules under this regime shortly after the Bill is introduced into LegCo.

After the regulatory framework is introduced, the HKMA will issue supervisory guidance outlining the key requirements and its approach to supervising AIs' OTC derivatives activities.

The HKMA will also continue its participation 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

Development of Hong Kong as a payment hub for renminbi to reinforce its status as the premier offshore renminbi business centre

The HKMA is taking a proactive approach in strengthening Hong Kong's renminbi related financial infrastructure to take advantage of the expanding offshore renminbi business opportunities. The extension of the operating hours of the renminbi RTGS system in 2012 has been well received by the banking sector, with an increasing volume and greater variety of payments executed in the evening hours.

Money settlement for investment funds

Following the launch of the CMU Fund Order Routing and Settlement Service in August 2009, which primarily deals with the routing of investment fund orders, the CMU will enhance the platform in 2013 to facilitate the money settlement of investment fund orders.

Trade repository for OTC derivatives

The transaction reporting function of the trade repository for supporting mandatory reporting under the regulatory regime in Hong Kong is scheduled for launch by mid-2013, just prior to the target implementation date of the regulatory regime itself. Development of the trade repository system's next phase will commence in 2013, with the focus on including the remaining most commonly traded products in the local market and those requested to be added by regulatory authorities. It is scheduled for completion by mid-2014.

Retail payment initiatives

The HKMA will continue with the implementation of the e-bill system and e-cheques as planned and conduct a series of promotional events to arouse public awareness and interest in these initiatives. In addition, it will consult the mobile payment industry on the recommendations set out in the NFC mobile payment consultancy report with a view to implementing an effective and interoperable infrastructure for Hong Kong.

New regulatory regime for stored value facilities and retail payment systems in Hong Kong

A public consultation on the proposed regulatory regime is planned in the first half of 2013. Responses from the consultation will be incorporated in the drafting of new legislation, which is expected to be introduced into LegCo for consideration in the second half of 2013.

Pan-Asian CSD Alliance project

The HKMA will continue to work with global tripartite repo system operators to allow local financial institutions to use their securities as collateral to obtain foreign currency liquidity from international financial institutions, and develop DvP links between Hong Kong's RTGS systems and the global tripartite repo systems. In addition, the HKMA will begin the development of a centralised corporate action platform to facilitate announcements and processing of corporate action events of debt securities. The centralised platform is expected to be launched in phases starting from the end of 2014.

Reserves Management

The Exchange Fund recorded an investment return of 4.4% in 2012. Despite the highly uncertain investment environment, the Investment Portfolio, excluding contributions from the Long-Term Growth Portfolio (LTGP), achieved a return of 8%.

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 mix of the Fund.

Broadly speaking, the Exchange Fund has two major 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, 79% of the assets are allocated to the US dollar and the Hong Kong dollar, and the remaining 21% 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, overseas investment properties, and Mainland bonds and equities. These assets had been housed under the LTGP. In November 2012, EFAC reviewed the HKMA's work in managing the LTGP. On the advice of EFAC, the Financial Secretary decided that the cap for the portfolio should be maintained at one-third of the Accumulated Surplus of the Exchange Fund. He also decided that all emerging market equities and bonds including Mainland assets would be grouped under the Investment Portfolio while private equity and real estate would remain in the LTGP, thereby allowing more room for the Exchange Fund to further pursue diversification of investments.

The Strategic Portfolio, established in 2007 to hold shares in Hong Kong Exchanges and Clearing Limited that were acquired by the Government for the account of the Exchange Fund for strategic purposes, is not included in the assessment of the Fund's investment performance because of the unique nature of this Portfolio.

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 listed 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 transfer knowledge and information from the market to in-house professionals.

Expenditure relating to the use of external managers includes fund management and custodian fees, transaction costs, and withholding and other taxes. The expenditure is primarily 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 2012

Global financial markets continued to be volatile. Amid heightened concerns about the future of the euro and the adverse impact on the economic environment in the euro area, major equity markets in developed economies suffered a correction in the second quarter that erased most of the gains in the previous quarter. Markets then rallied in the second half of the year, supported by further accommodative monetary policies of major central banks, and some compromise among US politicians to mitigate the negative effects of the "fiscal cliff" on the US economy.

On the bond markets, continued assurances of a prolonged low interest rate environment, additional asset purchases by the US Federal Reserve and, to some extent, the escalating European sovereign debt crisis, supported US Treasuries. The 10-year US Treasury yield kept below 2% for most of the year, while other major government bond yields moved largely in tandem with the Treasury yields.

On currency markets, the euro weakened in the second quarter as market sentiment deteriorated over the sovereign debt crisis in the European peripheral countries, but rebounded after the European Central Bank allayed investors' concerns by pledging to purchase euro area sovereign bonds. The yen weakened substantially against the dollar in the fourth quarter as the newly elected Prime Minister vowed to push for more aggressive easing to alleviate the stringent deflationary pressure in Japan.

The performance of major currency, bond and equity markets in 2012 is shown in Table 1.

Table 1 2012 market returns

Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+1.6%
Yen	-11.0%
Bond markets	
Relevant US Government Bond (1 - 3 years) Index	+0.4%
Equity markets [1]	
Standard & Poor's 500 Index	+13.4%
Hang Seng Index	+22.9%

[1] Market performance on equities is based on index price change during the year.

Reserves Management

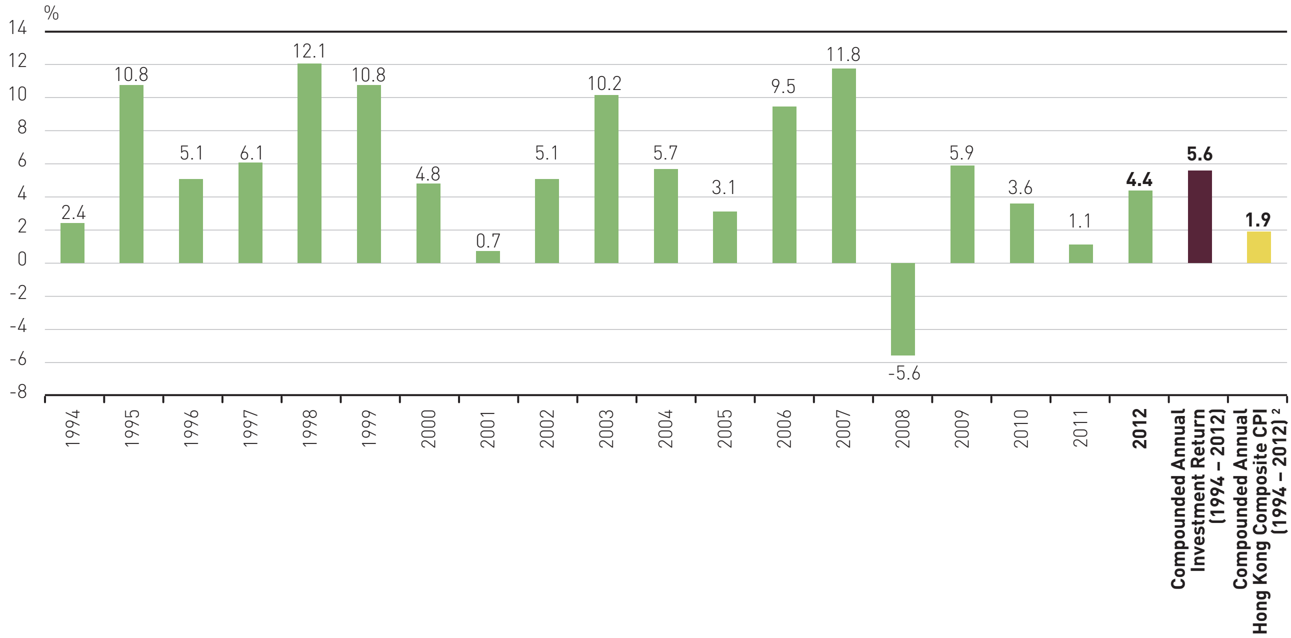
The Exchange Fund's performance

The Exchange Fund recorded an investment income of $111.6 billion in 2012, comprising gains from Hong Kong and foreign equities of $30.7 billion and $42.8 billion respectively, a total return from bonds and a valuation gain on other investments held by the investment holding subsidiaries of the Fund of $33.1 billion and $6.4 billion respectively, and a loss of $1.4 billion from foreign exchange revaluation. Apart from the $111.6 billion investment income, the valuation gain and dividend income of the Strategic Portfolio amounted to $0.8 billion.

The investment return of the Exchange Fund after excluding the Strategic Portfolio was 4.4%. The annual return of the Fund from 1994 to 2012 is set out in Chart 1. Table 2 shows the 2012 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 3.0% over the past three years, 1.8% over the past five years, 4.9% over the past 10 years and 5.6% since 1994.[1] Table 3 shows the currency mix of the Fund's assets on 31 December 2012.

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

Chart 1 **Investment return of the Exchange Fund (1994 – 2012)** [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]
2012	4.4%
3-year average (2010 – 2012)	3.0%
5-year average (2008 – 2012)	1.8%
10-year average (2003 – 2012)	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 2012 (including forward transactions)**

	HK$ billion	**%**
US dollar	2,122.1	76.3
Hong Kong dollar	193.3	7.0
Others [1]	465.7	16.7
Total	**2,781.1**	**100.0**

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

Corporate Functions

The HKMA continues to strengthen its ties with the media and the community in general to promote understanding of its work. At the same time, resources are continually reviewed and deployed to maintain banking and monetary stability in an increasingly complex and challenging global financial environment.

CORPORATE DEVELOPMENT

Media relations

The HKMA places great emphasis on maintaining effective and timely communications with the media to improve transparency and accessibility to its operations. In 2012, the HKMA continued to strengthen this relationship with the media and the public and enhance their understanding of the HKMA's policies and work. During the year, there were 86 open press events, comprising 18 press conferences, 19 stand-up interviews and 49 other public functions. A further 57 media interviews were arranged. Altogether 324 bilingual press releases were issued and a large number of media enquiries were handled each day.

In addition, nine media workshops were organised covering a wide range of topics to enable better understanding of the HKMA's operations and initiatives. The topics included prudential measures for mortgage lending, the implementation of regulatory requirements under Basel III, the operation of the Currency Board, and offshore renminbi business development, such as the introduction of the renminbi liquidity facility.

Chief Executive of the HKMA, Mr Norman Chan, briefs the media during the annual visit of the Hong Kong Association of Banks and the HKMA to the Mainland.

Public enquiries

The Public Enquiry Service handled 9,109 enquiries in 2012. The Service continues to be one of the key channels through which the HKMA communicates with the community and helps the public better understand its work.

Most enquiries were related to consumer banking issues, and banking policies and regulations. Notable examples were the prudential measures on mortgage loans and the prevention of money laundering and terrorist financing. Other enquiries covered such issues as personal renminbi business for non-Hong Kong residents, automatic teller machine chip cards and Hong Kong dollar fund flows. Chart 1 shows the number of enquiries received since 2008 and Chart 2 shows the breakdown by nature of the enquiries received in 2012.

Chart 1 Total number of public enquiries

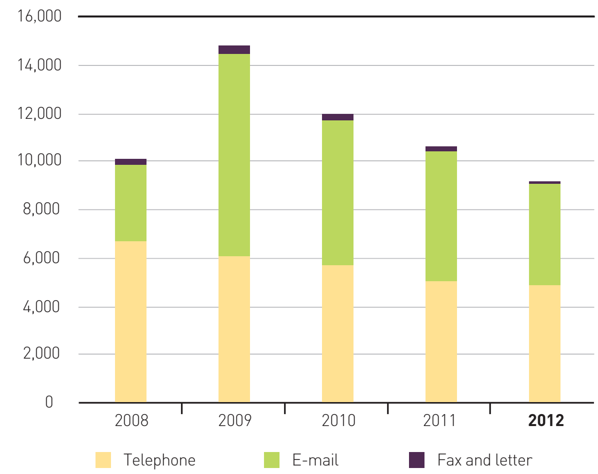
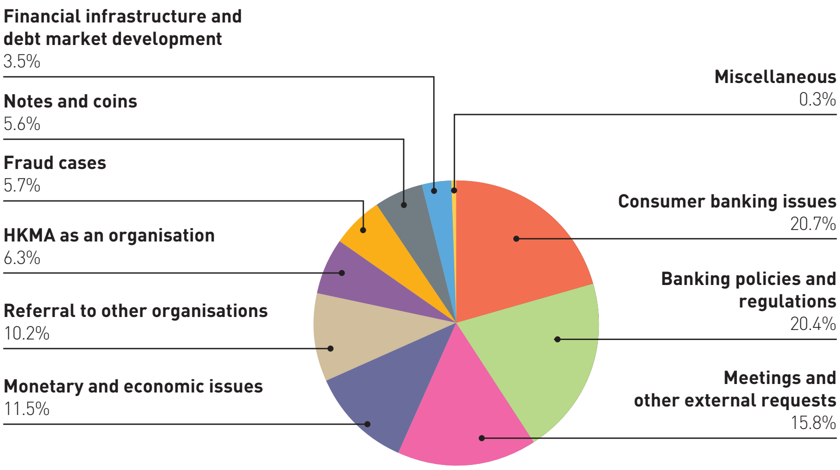


Chart 2 Nature of enquiries received in 2012



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 2011* received an Honourable Mention in the Hong Kong Management Association's 2012 Best Annual Reports Awards.

The HKMA website

The HKMA corporate website (www.hkma.gov.hk), with over 50,000 pages in three language versions, provides comprehensive and up-to-date information about the HKMA in an accessible manner. Its Really Simple Syndication (RSS) function helps users keep track of updates. It also contains the Register of Securities Staff of Authorized Institutions and the Register of Authorized Institutions and Local Representative Offices, both maintained under section 20 of the Banking Ordinance.

Public education programme

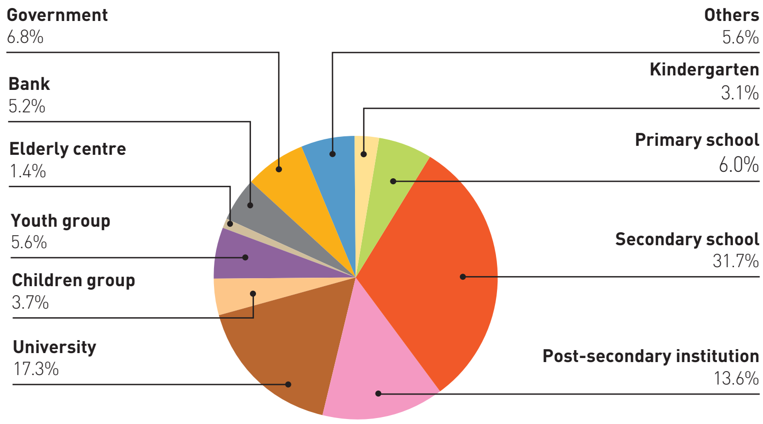
The Information Centre on the 55th Floor of Two International Finance Centre is an important resource for introducing the HKMA's work to the community and promoting public awareness of monetary and banking matters.

The Centre consists of an exhibition area and library, and is open to the public six days a week. There are displays on the history of money and banking in Hong Kong and the key policy objectives of the HKMA, and it provides information on Hong Kong's banknotes, Internet banking security, the payment systems and deposit protection in Hong Kong. During the year, the Centre received more than 39,000 visitors and held over 510 guided tours for schools and other groups (Chart 3). Over 413,000 people have visited the Centre since it opened in December 2003.

During the year, the Centre was refurbished for showcasing new exhibits and displays to improve services to the public. The Historical Timeline featured on the main wall of the Centre will also be revamped in February 2013 to include a children's version of the timeline showing the evolution of money in Hong Kong.

The Library, situated next to the Exhibition Area, contains material for the detailed study of Hong Kong's monetary, banking, financial affairs and central banking topics.

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



The refurbished Information Centre showcases new display elements and a children's version of timeline on the evolution of money in Hong Kong.

Corporate Functions

The HKMA continued to organise public education seminars on issues relevant to its work. In 2012, three seminars were held for over 2,500 students, teachers and members of the public. The main subjects were the Linked Exchange Rate system, Hong Kong's banknotes and the work of the HKMA.

The HKMA collaborated with the Leisure and Cultural Services Department in presenting the Hong Kong Currency Exhibition at the Hong Kong Museum of History, with the support of the three note-issuing banks. The Exhibition, the largest of its kind ever held in Hong Kong, brought together about 700 artefacts covering a wide array of relics, some of which have rarely been seen. To support the Exhibition, the HKMA donated to the Museum a collection of 5,331 Certificates of Indebtedness issued to note-issuing banks between 1935 and 1995, including the first batch issued in December 1935 following the establishment of the Exchange Fund the same year. The series was featured in the Exhibition.

The Hong Kong Currency Exhibition offers visitors an extensive overview of the development of the different types of currency used in Hong Kong, and the change in the purchasing power of the local currency over the years.

HUMAN RESOURCES

The HKMA needs to recruit, develop and maintain a highly professional workforce to support its policy objectives and to respond flexibly to changing work priorities. While it is an integral part of the Government, the HKMA is able to employ staff on terms different from those of the civil service to attract personnel with 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 workloads whenever possible.

Organisational changes

To strengthen the HKMA's risk infrastructure, the Risk Management and Compliance Division (RMC Division) was separated from the front office of the Reserves Management Department and put under the direct supervision of one of the Deputy Chief Executives in July 2012. The Pricing Unit, which oversees the process of setting and applying prices for revaluating the Exchange Fund's investment holdings, was transferred from the Banking Conduct Department to the RMC Division in August.

Staffing

In 2012, the establishment of the HKMA was 794. To ensure there were sufficient staff resources to address continuing pressure arising from the increasingly complex and dynamic financial environment, 24 new posts will be added to the establishment in January 2013, bringing the total establishment to 818 (an increase of 3%). These new posts will be deployed in the following areas:

(a) ***Enhancing the capability for macro-economic surveillance and market surveillance*** – Resources will be deployed to strengthen analyses and surveillance of macro data, and for improving surveillance and supervision of the over-the-counter (OTC) market to comply with the requirements of the Financial Stability Board (FSB).

(b) ***Enhancing prudential supervisory capability and strengthening investor protection*** – There is a need to keep up with the rapid growth and increasing complexity of the banking environment including the expanding variety of Mainland-related businesses, and to comply with the new regulations coming into force. Resources will be deployed for strengthening the supervision of banks and undertaking the related regulatory and policy development work.

(c) ***Promoting Hong Kong as the premier financial services hub, especially in offshore renminbi business, and as an asset/wealth management centre*** – A new regulatory framework for stored value facilities and retail payment systems is being planned, and resources are needed to commence work on policy development and the related legislative proposals. Support will also be enhanced for Hong Kong's participation in the FSB and in the activities of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).

(d) ***Enhancing capacity in investment, internal control and risk management of the Exchange Fund*** – With the expanding investment activities and coverage of new asset classes, additional investment specialists will be required to manage the investment portfolios, and resources will also be deployed to strengthen operational risk management, credit risk management and legal support.

Corporate Functions

Table 1 gives a breakdown of the establishment and strength of the HKMA.

Table 1 Establishment and strength of the HKMA on 1 January 2013

		Senior staff		Others	
Department	**Functions**	**Establishment**	**Strength**	**Establishment**	**Strength**
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	7	7
Banking Conduct Department	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 (AIs).	1	1	99	95
Banking Policy Department	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	30	30
Banking Supervision Department	To supervise day-to-day operations of AIs.	1	1	165	157
Enforcement Department	To focus on securities enforcement and complaint handling functions.	1	1	61	58
External Department	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	52	48
Financial Infrastructure Department	To develop and enhance the financial market infrastructure important for maintaining and strengthening Hong Kong as an international financial centre.	1	1	32	25
Monetary Management Department	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	40	40
Research Department	To conduct research and analysis on economic and international financial market developments in Hong Kong and other economies.	1	1	38	37
Reserves Management Department	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	58	55
Risk Management and Compliance Division	To formulate and monitor compliance with investment guidelines, and manage financial and operational risks, for promoting the integrity and the soundness of reserves management.	–	–	32	29
Office of the General Counsel	To provide in-house legal support and advice.	1	1	21	18
Corporate Services Department	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	158	154
Internal Audit Division	To provide audit services through assisting management in controlling risks, monitoring compliance and improving the efficiency of internal control systems and procedures.	–	–	10	9
Total		**15**	**15**	**803**	**762**

Temporary resources will continue to be deployed to meet other work demands. The HKMA transfers staff on secondment to other international or local organisations, such as the International Monetary Fund (IMF) 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 Governance Sub-Committee (GSC) through the Exchange Fund Advisory Committee (EFAC) 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 light of recommendations made to him by the GSC through EFAC, taking into account the GSC's assessment of the performance of the HKMA in the preceding year, the pay survey findings of the financial sector conducted by independent HR consultants and any other relevant 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 HR 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 2012 are shown in Table 2.

Table 2 Remuneration packages of HKMA senior staff in 2012[1]

$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff[2]	1	3	12
Annualised pay			
Fixed pay	6,000	5,491	3,482
Variable pay	2,456	1,709	824
Other benefits[3]	954	608	423

Notes:

1 Except for annual leave accrued, the actual remuneration received by staff during 2012 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 focuses on developing staff capabilities to meet operational demands, career development and new challenges. During the year, staff were provided with 3,010 training days. These included 1,360 days of horizontal training in general skills, and 1,650 days of vertical training in job-specific issues. Each staff received on average 3.9 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. Other programmes included team-building workshops; courses on English writing skills for banking colleagues and junior managers; and courses on Putonghua, and training on computer skills for staff at various ranks. Workshops on corporate image and business etiquette, communications and presentation skills and on-site interface skills were attended by managerial staff. An advanced leadership course run by an overseas organisation and a national studies course at Peking University, organised by the Hong Kong Government, were also attended by managerial staff. Training for senior staff included executive coaching; a locally-run executive leadership programme; an internationally-run seminar on global financial issues; and central banking courses organised by the Federal Reserve Bank of New York.

In addition to formal training, staff briefings were conducted by senior executives and external speakers on a wide range of topics related to the work of the HKMA, including briefings on professional ethics and corruption prevention.

Throughout the year, training on specific topics was organised for staff in the banking departments. The topics in 2012 included updates on Basel III, renminbi business, the regulation of Mandatory Provident Fund intermediaries, anti-money laundering, and trade financing. External training consultants were also engaged to provide courses for banking supervisory staff on advanced bank risks analysis, and commercial and corporate lending.

The HKMA runs a Training Sponsorship Scheme to help staff pursue degree or diploma courses, professional qualifications or short-term courses relevant to the work of the HKMA. Partial reimbursement of membership dues of relevant professional bodies is also provided.

GENERAL ADMINISTRATION

The HKMA continues to streamline its work to improve efficiency and cost-effectiveness to cope with the increasing workload. Business continuity plans are reviewed constantly, and drills on evacuation and the activation of the back-up office are held annually. The Event Management Team keeps a close watch on influenza alerts and other relevant infectious diseases to ensure that precautionary and contingency measures are taken in accordance with the Corporate Business Contingency Plan.

The HKMA adopts multiple measures to protect and preserve the environment, including the use of recycled paper, the installation of energy-saving devices, and recycling various office or daily consumables, such as paper, printer cartridges, batteries and bottles. Green achievements in 2012 included reduction in electricity consumption by the main general office (1.6%), reduction in photocopying (13.1%) and reduction in envelope consumption (46.1%). Staff continued to give their generous support to regular campaigns in collecting clothes, toys and other reusable items for donation to charities.

During the year, staff teams participated in a number of charity walks including the Green Power Hike, the Sowers Action Charity Marathon, the UNICEF Half Marathon and the Oxfam Trailwalker, in which the HKMA Corporate Team was awarded the honour of "Super Trailwalker" by completing the 100-kilometre walk within 18 hours. Staff also took part in the Blood Donation Day and the Community Chest's Dress Casual Day, and gave more than 100 hours of free time to voluntary services, including organising an outing for the students of Chak Yan Centre. In recognition of the HKMA's continuous commitment to corporate citizenship, the Hong Kong Council of Social Service has extended the usage of "5 Years Plus Caring Organisation Logo" to the HKMA up to 28 February 2014.

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 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 2012 and the budgeted expenditure for core activities in 2013 are shown in Table 3. The difference between the 2012 actual expenditure and the 2013 budget arises mainly from an increase in staff costs, including the full-year effect of staff increases in 2012 reflecting the strengthening of support for essential activities in different areas of the HKMA's work, and the increase of 24 posts in 2013 for enhancing capabilities in market surveillance, supervision and investment activities. The request for 2013 was approved 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 2013. Expenditure continued in 2012 on the programme to upgrade Hong Kong's financial infrastructure, including strengthening Hong Kong's local and regional payment infrastructure, developing and implementing by phases the trade repository system, and keeping the 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 and securely. 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	2012 Budget*	2012 Actual	2013 Budget*
Staff costs	942		1,057
Salaries and other staff costs		834	
Retirement benefit costs		69	
Premises expenses			
Operating lease charges	17	16	19
Other premises expenses (including utility charges and management fees)	48	45	49
General operating costs			
Maintenance of office and computer equipment	67	60	64
Financial information and communication services (including trading, dealing terminals and data link charges)	54	44	58
External relations (including international meetings)	54	30	57
Professional and other services	45	26	54
Training	9	8	10
Others	23	22	24
Total administrative expenditure	**1,259**	**1,154**	**1,392**

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

Table 4 Additional expenses

$ million	2012 Budget*	2012 Actual	2013 Budget*
Subsidy to the Hong Kong Institute for Monetary Research	21	17	21
Premises expenses of international financial organisations in Hong Kong	32	32	34
Service fees for financial infrastructure	97	80	146

* 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 (CMU). For 2013, revenue from licence fees is estimated to be $132 million (2012: $132 million), and costs recovered from the Hong Kong Deposit Protection Board and the other income components (excluding investment income) are estimated to total $83 million (2012: $80 million).

Financial disclosure

The HKMA adopts best practices in financial disclosure as far as they are consistent with central banking operations. These standards include the reporting requirements laid down by the Special Data Dissemination Standard of the IMF. In the absence of specific reporting requirements applying to central banking institutions, the HKMA adopts 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 2012 for all time-critical systems. To ensure continued reliability of the HKMA's information technology (IT) systems, ageing components of the IT infrastructure were updated in batches. The Division implemented a new IT security information and event management software package to automate the system message logs review process and enable early security warning. As mobile technology changes consumer and business behaviour, the Division continued to explore and deploy new arrangements for supporting staff on the move to enhance productivity.

In line with the Government's policy commitment, the HKMA improved the accessibility of its corporate website and five related websites – Online Learning, the Register of Securities Staff of Authorized Institutions, the Register of Authorized Institutions and Local Representative Offices, the CMU Bond Price Bulletin and the Government Bond Programme Website. They now conform to the World Wide Web Consortium's Web Content Accessibility Guidelines 2.0 Level AA standard.

The revamp of the banking departments' existing banking supervisory information system continued in 2012 to meet the evolving needs of the departments for IT support in discharging their responsibilities. The revamp project covers three main areas – the new system infrastructure, development of business intelligence tools and enhancement of the banking return electronic submission system. The project has been progressing on schedule since its commencement in February 2012.

The Division continued to support the Hong Kong Deposit Protection Board in improving its payout efficiency and upgrading the capacity of the system to cater for multiple concurrent payouts.

SETTLEMENT SERVICES

The Settlement Section provides settlement and operational support to ensure sufficient and reliable transfers of funds or assets of the Exchange Fund arising from reserves management, monetary operations and other activities, as well as administration of the HKMA. In view of the potential settlement risks from the wide range of trading products and markets undertaken by the HKMA, the Settlement Section remains vigilant towards operational issues that may arise during the provision of settlement services. It also supports the ongoing effectiveness of the in-house investment and settlement processing systems. The Settlement Section is committed to effective risk control mechanisms for settlement and operational support, and ensuring the segregation of duties and avoiding conflicts of interest between monetary operations and reserves management functions of the HKMA. As such, the Section is 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 12 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:

- implementation of the Basel III framework, including preparing the legislative amendments to the Banking (Capital) Rules

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

- formulation of the proposed regulatory regime for stored value facilities and retail payment systems

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

- implementation of the HKMA's regulatory regime under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance

- deliberation on effective resolution regimes to strengthen cross-border resolution for global systemically important financial institutions, including participation in the FSB Steering Group for resolution regimes and the legal advisory panel to that Steering Group co-chaired by the FSB Secretariat and the IMF, 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 participation in the FSB Data Gaps Implementation Group

- conduct and management of litigation matters involving the HKMA.

The OGC 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.

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 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 significant risks of the HKMA. In addition to auditing the prudential banking supervision function, the Division also reviewed processes of other banking departments including Banking Conduct and Enforcement. The Division advised on major system development projects and responded to management requests on internal-control matters, as well as advising senior executives on internal control issues.

To keep abreast of developments in practices in the internal audit profession and other central banks, the Head of the Division attended two central banking courses organised by Central Banking Publication Limited for internal audit heads and risk managers. He participated as a guest speaker and exchanged views and shared experiences in risk management and audit matters with other delegates. In addition, the Division's professional staff attended 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. There are two high-level committees under the HKMA's risk management framework, the Macro Surveillance Committee and the Risk Committee.

The terms of reference of the Macro Surveillance 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
- to review existing measures for managing risks in the monetary and financial system to identify possible gaps and ensure the adequacy of these measures
- to encourage cross-department sharing of relevant information on macro surveillance with a view to enhancing macro surveillance capability of the HKMA.

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 which promotes the proper levels of authorisation and controls.

Both Committees are chaired by the Chief Executive and meet regularly to review the risk assessments made by 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

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 122 to 203, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2012, 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 2012, 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.

LAU Sun-wo
Assistant Director of Audit
for Director of Audit

8 April 2013

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

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2012

(Expressed in millions of Hong Kong dollars)	Note	Group		Fund	
		2012	2011	**2012**	2011
INCOME					
Interest income		**17,570**	21,114	**15,971**	19,718
Dividend income		**10,650**	9,507	**10,324**	9,745
Income from investment properties		**253**	–	**–**	–
Net realised and revaluation gains		**83,998**	3,683	**81,082**	3,063
Net exchange loss		**(1,552)**	(8,860)	**(1,435)**	(9,080)
Investment income	4(a)	**110,919**	25,444	**105,942**	23,446
Bank licence fees		**132**	136	**132**	136
Other income		**641**	781	**104**	93
TOTAL INCOME		**111,692**	26,361	**106,178**	23,675
EXPENDITURE					
Interest expense on placements by Fiscal Reserves, HKSAR government funds and statutory bodies	4(b)	**(45,757)**	(42,589)	**(45,757)**	(42,589)
Other interest expense	4(c)	**(1,662)**	(2,043)	**(1,221)**	(1,779)
Operating expenses	4(d)	**(3,252)**	(2,963)	**(2,884)**	(2,659)
Note and coin expenses	4(e)	**(346)**	(237)	**(346)**	(237)
Write back of impairment losses on loans/ (Impairment losses on loans)		**6**	(3)	**–**	–
TOTAL EXPENDITURE		**(51,011)**	(47,835)	**(50,208)**	(47,264)
SURPLUS/(DEFICIT) BEFORE SHARE OF PROFIT OF ASSOCIATE AND JOINT VENTURES		**60,681**	(21,474)	**55,970**	(23,589)
Share of profit of associate and joint ventures, net of tax		**654**	89	**–**	–
Gain from disposal of a joint venture		**7**	–	**–**	–
SURPLUS/(DEFICIT) BEFORE TAXATION		**61,342**	(21,385)	**55,970**	(23,589)
Income tax		**(3)**	(185)	**–**	–
SURPLUS/(DEFICIT) FOR THE YEAR		**61,339**	(21,570)	**55,970**	(23,589)
ATTRIBUTABLE TO:					
Owner of the Fund		**61,300**	(21,585)	**55,970**	(23,589)
Non-controlling interests		**39**	15	**–**	–
		61,339	(21,570)	**55,970**	(23,589)

The notes on pages 128 to 203 form part of these financial statements.

Exchange Fund – Statement of Comprehensive Income

for the year ended 31 December 2012

(Expressed in millions of Hong Kong dollars)	Note	Group 2012	Group 2011	Fund 2012	Fund 2011
SURPLUS/(DEFICIT) FOR THE YEAR		**61,339**	(21,570)	**55,970**	(23,589)
OTHER COMPREHENSIVE INCOME					
Available-for-sale securities					
fair value changes on revaluation	29	**2,259**	(284)	**–**	–
fair value changes on disposal transferred to income and expenditure account	29	**(38)**	(51)	**–**	–
tax effect	29	**(53)**	(10)	**–**	–
Cash flow hedges					
fair value changes on revaluation	29	**–**	3	**–**	–
fair value changes transferred to income and expenditure account	29	**6**	10	**–**	–
tax effect	29	**(1)**	(2)	**–**	–
Exchange differences on translation of financial statements of overseas subsidiaries and joint ventures	29	**1**	2	**–**	–
Reserves released on disposal of a joint venture	29	**(7)**	–	**–**	–
OTHER COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR, NET OF TAX		**2,167**	(332)	**–**	–
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR		**63,506**	(21,902)	**55,970**	(23,589)
TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR ATTRIBUTABLE TO:					
Owner of the Fund		**63,467**	(21,918)	**55,970**	(23,589)
Non-controlling interests		**39**	16	**–**	–
		63,506	(21,902)	**55,970**	(23,589)

The notes on pages 128 to 203 form part of these financial statements.

Exchange Fund – Balance Sheet

as at 31 December 2012

(Expressed in millions of Hong Kong dollars)	Note	Group 2012	Group 2011	Fund 2012	Fund 2011
ASSETS					
Cash and money at call	6	**51,353**	60,564	**49,978**	60,138
Placements with banks and other financial institutions	7	**148,042**	171,805	**138,332**	161,529
Derivative financial instruments	8(a)	**6,175**	4,355	**4,429**	2,796
Financial assets designated at fair value	9	**2,492,917**	2,212,397	**2,479,796**	2,203,217
Available-for-sale securities	10	**43,608**	23,464	**493**	493
Held-to-maturity securities	11	**9,324**	8,365	**–**	–
Loan portfolio	12	**25,895**	33,136	**–**	–
Gold	13	**862**	817	**862**	817
Other assets	14	**49,313**	23,522	**48,332**	22,526
Investments in subsidiaries	15	**–**	–	**55,699**	33,278
Interests in associate and joint ventures	16	**5,242**	3,264	**–**	–
Investment properties	17	**16,380**	3,126	**–**	–
Property, plant and equipment	18(a)	**3,339**	3,423	**3,176**	3,238
TOTAL ASSETS		**2,852,450**	2,548,238	**2,781,097**	2,488,032
LIABILITIES AND EQUITY					
Certificates of Indebtedness	19	**289,837**	258,702	**289,837**	258,702
Government-issued currency notes and coins in circulation	19	**9,934**	9,888	**9,934**	9,888
Balance of the banking system	20	**255,851**	148,684	**255,851**	148,684
Derivative financial instruments	8(a)	**2,593**	935	**1,652**	672
Placements by banks and other financial institutions	21	**–**	24,547	**–**	24,547
Placements by Fiscal Reserves	22	**717,536**	663,507	**717,536**	663,507
Placements by Hong Kong Special Administrative Region government funds and statutory bodies	23	**167,913**	126,249	**167,913**	126,249
Exchange Fund Bills and Notes issued	24	**688,214**	655,750	**688,484**	655,750
Bank loans	25	**9,250**	1,876	**–**	–
Mortgage-backed securities issued	26	**214**	367	**–**	–
Other debt securities issued	27	**36,365**	41,058	**–**	–
Other liabilities	28	**33,044**	38,639	**26,006**	32,119
Total liabilities		**2,210,751**	1,970,202	**2,157,213**	1,920,118
Accumulated surplus	29	**637,268**	575,968	**623,884**	567,914
Revaluation reserve	29	**3,917**	1,744	**–**	–
Translation reserve	29	**36**	42	**–**	–
Total equity attributable to owner of the Fund		**641,221**	577,754	**623,884**	567,914
Non-controlling interests	29	**478**	282	**–**	–
Total equity		**641,699**	578,036	**623,884**	567,914
TOTAL LIABILITIES AND EQUITY		**2,852,450**	2,548,238	**2,781,097**	2,488,032

Norman T. L. Chan
Monetary Authority
8 April 2013

The notes on pages 128 to 203 form part of these financial statements.

Exchange Fund – Statement of Changes in Equity

for the year ended 31 December 2012

		Attributable to owner of the Fund					
(Expressed in millions of Hong Kong dollars)	Note	Accumulated surplus	Revaluation reserve	Translation reserve	Total attributable to owner of the Fund	Non-controlling interests	Total
Group							
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
At 1 January 2012		**575,968**	**1,744**	**42**	**577,754**	**282**	**578,036**
Surplus for the year	29	**61,300**	**–**	**–**	**61,300**	**39**	**61,339**
Other comprehensive income/(loss) for the year	29	**–**	**2,173**	**(6)**	**2,167**	**–**	**2,167**
Total comprehensive income/(loss) for the year		**61,300**	**2,173**	**(6)**	**63,467**	**39**	**63,506**
Capital injection by non-controlling interests	29	**–**	**–**	**–**	**–**	**167**	**167**
Dividends paid to non-controlling interests	29	**–**	**–**	**–**	**–**	**(10)**	**(10)**
At 31 December 2012		**637,268**	**3,917**	**36**	**641,221**	**478**	**641,699**
Fund							
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
At 1 January 2012		**567,914**	**–**	**–**	**567,914**	**–**	**567,914**
Surplus and total comprehensive income for the year	29	**55,970**	**–**	**–**	**55,970**	**–**	**55,970**
At 31 December 2012		**623,884**	**–**	**–**	**623,884**	**–**	**623,884**

The notes on pages 128 to 203 form part of these financial statements.

Exchange Fund – Statement of Cash Flows

for the year ended 31 December 2012

(Expressed in millions of Hong Kong dollars)	Note	Group 2012	Group 2011	Fund 2012	Fund 2011
Cash flows from operating activities					
Surplus/(Deficit) before share of profit of associate and joint ventures		**60,681**	(21,474)	**55,970**	(23,589)
Adjustments for:					
Interest income	4(a)	**(17,570)**	(21,114)	**(15,971)**	(19,718)
Dividend income	4(a)	**(10,650)**	(9,507)	**(10,324)**	(9,745)
Change in fair value of investment properties	4(a)	**133**	134	**–**	–
Net gains on disposal of available-for-sale securities	4(a)	**(1,110)**	(719)	**–**	–
Net gains on disposal of held-to-maturity securities	4(a)	**(5)**	–	**–**	–
Interest expense	4(b) & 4(c)	**47,419**	44,632	**46,978**	44,368
Depreciation	4(d)	**160**	151	**121**	117
Elimination of exchange differences and other non-cash items		**389**	(422)	**350**	(542)
Interest received		**18,317**	21,582	**16,680**	19,945
Interest paid		**(47,370)**	(44,857)	**(47,043)**	(44,421)
Dividends received		**10,953**	9,317	**10,284**	9,193
Income tax paid		**(131)**	(188)	**–**	–
		61,216	(22,465)	**57,045**	(24,392)
Change in fair value of derivatives and other debt securities issued		**(824)**	(2,525)	**(655)**	(2,648)
Change in carrying amount of:					
– placements with banks and other financial institutions		**(8,676)**	1,900	**(402)**	778
– financial assets designated at fair value		**(185,848)**	(90,337)	**(181,907)**	(85,560)
– loan portfolio		**7,244**	2,117	**–**	–
– gold		**(45)**	(85)	**(45)**	(85)
– other assets		**(26,610)**	(4,016)	**(26,836)**	(3,794)
– Certificates of Indebtedness, government-issued currency notes and coins in circulation		**31,181**	33,752	**31,181**	33,752
– balance of the banking system		**107,167**	(18)	**107,167**	(18)
– placements by banks and other financial institutions		**(24,547)**	1,360	**(24,547)**	1,360
– placements by Fiscal Reserves		**54,029**	71,225	**54,029**	71,225
– placements by Hong Kong Special Administrative Region government funds and statutory bodies		**41,664**	49,489	**41,664**	49,489
– Exchange Fund Bills and Notes issued		**32,464**	2,029	**32,734**	1,529
– other liabilities		**(5,800)**	11,007	**(6,048)**	11,108
Net cash from operating activities		**82,615**	53,433	**83,380**	52,744

Exchange Fund – Statement of Cash Flows (continued)

for the year ended 31 December 2012

(Expressed in millions of Hong Kong dollars)	Note	Group 2012	Group 2011	Fund 2012	Fund 2011
Cash flows from investing activities					
Net cash outflow from acquisition of a subsidiary	16	**(690)**	–	**–**	–
Loans to subsidiaries		**–**	–	**(22,421)**	(16,450)
(Increase)/Decrease in investment in joint ventures		**(4,292)**	303	**–**	–
Proceeds from sale or redemption of available-for-sale securities		**4,327**	3,050	**–**	–
Purchase of available-for-sale securities		**(21,138)**	(13,805)	**–**	–
Proceeds from sale or redemption of held-to-maturity securities		**971**	1,520	**–**	–
Purchase of held-to-maturity securities		**(1,926)**	(1,775)	**–**	–
Proceeds from disposal of a joint venture		**137**	–	**–**	–
Purchase of investment properties		**(5,191)**	(3,421)	**–**	–
Purchase of property, plant and equipment		**(76)**	(73)	**(59)**	(47)
Dividends received from subsidiaries		**–**	–	**363**	362
Net cash used in investing activities		**(27,878)**	(14,201)	**(22,117)**	(16,135)
Cash flows from financing activities					
Bank loans raised		**3,209**	1,876	**–**	–
Proceeds from issue of other debt securities		**19,077**	28,526	**–**	–
Redemption of mortgage-backed securities issued		**(153)**	(1,139)	**–**	–
Redemption of other debt securities issued		**(23,661)**	(26,719)	**–**	–
Capital injection by non-controlling interests		**167**	4	**–**	–
Dividends paid to non-controlling interests		**(10)**	(10)	**–**	–
Net cash from/(used in) financing activities		**(1,371)**	2,538	**–**	–
Net increase in cash and cash equivalents		**53,366**	41,770	**61,263**	36,609
Cash and cash equivalents at 1 January		**254,791**	212,464	**244,387**	207,236
Effect of foreign exchange rate changes		**(344)**	557	**(350)**	542
Cash and cash equivalents at 31 December	30	**307,813**	254,791	**305,300**	244,387

The notes on pages 128 to 203 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 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).

For acquisition of assets that does not constitute a business under HKFRS 3, Business Combinations, the acquisition cost is allocated to the individual identifiable assets acquired and liabilities assumed on the basis of their relative fair values at the date of acquisition and recognised in the Group financial statements. Such acquisition does not give rise to any goodwill.

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.

When the Group ceases to have significant influence over an associate or joint control over a joint venture, it is accounted for as a disposal of the entire interest in the associate or the joint venture, with a resulting gain or loss being recognised in the income and expenditure account. Any interest retained in the associate or the joint venture at the date when significant influence or joint control is lost is recognised at fair value and this amount is regarded as the fair value on initial recognition of a financial asset (note 2.5.1) or, when appropriate, the cost on initial recognition of an investment in an associate.

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

- 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).

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

2.5.2.5 Available-for-sale securities

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

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

The investment by the Fund in shares of the Bank for International Settlements is held in order to participate in it on a long-term basis. As these shares do not have a quoted market price in an active market and the fair value cannot be reliably measured, they are carried at cost less impairment losses, if any (note 2.9).

When available-for-sale securities are sold, gains or losses on disposal include the difference between the net sale proceeds and the carrying amount, and the accumulated fair value adjustments which are released from equity to the income and expenditure account.

2.5.2.6 Other financial liabilities

Other financial liabilities are financial liabilities other than trading liabilities and those designated at fair value.

Other financial liabilities repayable on demand are stated at the principal amount payable. These include Certificates of Indebtedness, government-issued currency notes and coins in circulation (note 2.5.2.7), the balance of the banking system, placements by Fiscal Reserves, placements by the Bond Fund and placements by the Deposit Protection Scheme Fund.

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, other placements by HKSAR government funds and statutory bodies, bank loans, mortgage-backed securities 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. The fair 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 2.5.3. 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 as receivables in "placements with banks and other financial institutions" and are carried 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 2.5.3. 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 qualify as fair value hedges are measured at fair value, with fair value changes recognised in the income and expenditure account, together with any changes in the fair value of the hedged item attributable to the risk being hedged.

When (a) 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 independent professional valuers or investment managers, 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. For investment properties that are measured at fair value, the amount of deferred tax recognised is measured using the tax rates that would apply on sale of those assets at their carrying value at the reporting date on the presumption that their carrying amounts are recovered entirely through sale. In all other cases, the amount of deferred tax recognised is measured based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. Deferred tax assets and liabilities are not discounted.

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.

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

3.1 Amendments to HKAS 12, Income Taxes – Deferred Tax: Recovery of Underlying Assets

The amendments to HKAS 12 introduce a rebuttable presumption that deferred tax on investment property carried at fair value under HKAS 40, Investment Property, shall be measured reflecting the tax consequences of recovering the carrying amount of the investment property through sale. This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.

The Group reviewed its investment properties and concluded that the related deferred tax has been measured on the presumption that their carrying amounts are recovered entirely through sale. There is no material impact on the adoption of the amendments to HKAS 12.

3.2 Amendments to HKFRS 7, Financial Instruments: Disclosures – Disclosures – Transfers of Financial Assets

The amendments to HKFRS 7 expand the existing disclosure requirements for transferred financial assets that are not derecognised in their entirety, and introduce new disclosure requirements for transferred financial assets that are derecognised in their entirety where the entities have continuing involvement in them.

The Group did not have any significant transfers of financial assets in previous periods or the current period which require disclosure in the current accounting period under the amendments and these amendments have had no material impact on the contents of the financial statements.

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

4 INCOME AND EXPENDITURE

(a) Investment income

	Group		Fund	
	2012	2011	**2012**	2011
Interest income:				
– from derivative financial instruments	**414**	440	**414**	440
– from financial assets designated at fair value	**15,410**	19,091	**15,060**	18,768
– from other financial assets	**1,746**	1,583	**497**	510
	17,570	21,114	**15,971**	19,718
Dividend income:				
– from financial assets designated at fair value	**10,114**	9,367	**9,959**	9,367
– from other financial assets	**536**	140	**15**	16
– from subsidiaries	**–**	–	**350**	362
	10,650	9,507	**10,324**	9,745
Income from investment properties:				
– rental income	**386**	134	**–**	–
– change in fair value on revaluation	**(133)**	(134)	**–**	–
	253	–	**–**	–
Net realised and revaluation gains/(losses):				
– on derivative financial instruments	**4,059**	(544)	**4,057**	(487)
– on financial assets and financial liabilities designated at fair value	**78,824**	3,508	**77,025**	3,550
– on disposal of available-for-sale securities	**1,110**	719	**–**	–
– on disposal of held-to-maturity securities	**5**	–	**–**	–
	83,998	3,683	**81,082**	3,063
Net exchange loss	**(1,552)**	(8,860)	**(1,435)**	(9,080)
TOTAL	**110,919**	25,444	**105,942**	23,446

(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 and Fund	
	2012	2011
Interest on placements by Fiscal Reserves:		
– at a fixed rate determined annually[1]	**37,749**	36,958
– at market-based rates	**1**	1
Interest on placements by HKSAR government funds and statutory bodies:		
– at a fixed rate determined annually[1]	**8,006**	5,629
– at market-based rates	**1**	1
TOTAL	**45,757**	42,589

[1] This rate has been fixed at 5.6% per annum for 2012 (2011: 6.0% – notes 22 and 23).

(c) Other interest expense

	Group		Fund	
	2012	2011	**2012**	2011
Interest on Exchange Fund Bills and Notes issued	**1,168**	1,667	**1,168**	1,667
Interest expense on derivative financial instruments	**88**	47	**22**	21
Interest expense on other debt securities issued designated at fair value and trading liabilities	**17**	29	**15**	26
Interest expense on other financial liabilities	**389**	300	**16**	65
TOTAL	**1,662**	2,043	**1,221**	1,779

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

(d) Operating expenses

	Group		Fund	
	2012	2011	**2012**	2011
Staff costs				
Salaries and other staff costs	**1,012**	917	**834**	751
Retirement benefit costs	**79**	67	**69**	59
Premises and equipment expenses				
Depreciation	**160**	151	**121**	117
Rental expenses under operating leases	**58**	44	**45**	42
Other premises expenses	**59**	53	**48**	45
General operating costs				
Maintenance of office and computer equipment	**68**	58	**60**	52
Financial information and communication services	**50**	46	**44**	40
External relations	**39**	38	**30**	29
Service fees for financial infrastructure	**80**	51	**80**	51
Professional and other services	**54**	48	**26**	28
Training	**9**	8	**8**	7
Others	**57**	22	**39**	25
Investment management and custodian fees				
Management and custodian fees	**885**	825	**844**	795
Transaction costs	**170**	202	**165**	186
Withholding tax	**432**	399	**432**	399
Others	**40**	34	**39**	33
TOTAL	**3,252**	2,963	**2,884**	2,659

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

	Group	
	2012	2011
Fixed pay	**64.3**	60.9
Variable pay	**18.1**	15.0
Other benefits	**7.9**	6.9
	90.3	82.8

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$	**2012**	2011
3,500,001 to 4,000,000	**–**	5
4,000,001 to 4,500,000	**6**	2
4,500,001 to 5,000,000	**2**	3
5,000,001 to 5,500,000	**2**	1
5,500,001 to 6,000,000	**1**	1
6,000,001 to 6,500,000	**1**	–
6,500,001 to 7,000,000	**–**	1
7,000,001 to 7,500,000	**1**	2
7,500,001 to 8,000,000	**1**	–
8,000,001 to 8,500,000	**1**	–
9,000,001 to 9,500,000	**1**	1
	16	16

(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 – 2012				
	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	51,353	–	–	51,353	–	–	–
Placements with banks and other financial institutions	7	148,042	–	–	148,042	–	–	–
Derivative financial instruments	8(a)	6,175	6,175	–	–	–	–	–
Financial assets designated at fair value	9	2,492,917	–	2,492,917	–	–	–	–
Available-for-sale securities	10	43,608	–	–	–	–	43,608	–
Held-to-maturity securities	11	9,324	–	–	–	9,324	–	–
Loan portfolio	12	25,895	–	–	25,895	–	–	–
Others		49,122	–	–	49,122	–	–	–
FINANCIAL ASSETS		2,826,436	6,175	2,492,917	274,412	9,324	43,608	–
Certificates of Indebtedness	19	289,837	–	–	–	–	–	289,837
Government-issued currency notes and coins in circulation	19	9,934	–	–	–	–	–	9,934
Balance of the banking system	20	255,851	–	–	–	–	–	255,851
Derivative financial instruments	8(a)	2,593	2,593	–	–	–	–	–
Placements by Fiscal Reserves	22	717,536	–	–	–	–	–	717,536
Placements by HKSAR government funds and statutory bodies	23	167,913	–	–	–	–	–	167,913
Exchange Fund Bills and Notes issued	24	688,214	–	688,214	–	–	–	-
Bank loans	25	9,250	–	–	–	–	–	9,250
Mortgage-backed securities issued	26	214	–	–	–	–	–	214
Other debt securities issued	27	36,365	–	340	–	–	–	36,025
Others		32,339	–	–	–	–	–	32,339
FINANCIAL LIABILITIES		2,210,046	2,593	688,554	–	–	–	1,518,899

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

			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.)

	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 – 2012			
Cash and money at call	6	49,978	–	–	49,978	–	–	–
Placements with banks and other financial institutions	7	138,332	–	–	138,332	–	–	–
Derivative financial instruments	8(a)	4,429	4,429	–	–	–	–	–
Financial assets designated at fair value	9	2,479,796	–	2,479,796	–	–	–	–
Available-for-sale securities	10	493	–	–	–	–	493	–
Others		48,311	–	–	48,311	–	–	–
FINANCIAL ASSETS		2,721,339	4,429	2,479,796	236,621	–	493	–
Certificates of Indebtedness	19	289,837	–	–	–	–	–	289,837
Government-issued currency notes and coins in circulation	19	9,934	–	–	–	–	–	9,934
Balance of the banking system	20	255,851	–	–	–	–	–	255,851
Derivative financial instruments	8(a)	1,652	1,652	–	–	–	–	–
Placements by Fiscal Reserves	22	717,536	–	–	–	–	–	717,536
Placements by HKSAR government funds and statutory bodies	23	167,913	–	–	–	–	–	167,913
Exchange Fund Bills and Notes issued	24	688,484	–	688,484	–	–	–	–
Others		25,913	–	–	–	–	–	25,913
FINANCIAL LIABILITIES		2,157,120	1,652	688,484	–	–	–	1,466,984

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

				Fund – 2011				
	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	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.)

6 CASH AND MONEY AT CALL

	Group		Fund	
	2012	2011	**2012**	2011
At amortised cost				
Balance with central banks	**852**	25,498	**852**	25,498
Balance with banks	**50,501**	35,066	**49,126**	34,640
TOTAL	**51,353**	60,564	**49,978**	60,138

7 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2012	2011	**2012**	2011
At amortised cost				
Placements in respect of reverse repurchase agreements:				
– with central banks	**38,782**	38,863	**38,782**	38,863
– with banks and other financial institutions	**8,461**	4,849	**8,461**	4,849
Other placements with banks	**100,799**	128,093	**91,089**	117,817
TOTAL	**148,042**	171,805	**138,332**	161,529

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			
	2012		2011		2012		2011	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	1,886	771	1,535	138	1,832	–	1,472	1
Interest rate futures contracts	–	–	1	–	–	–	1	–
Equity derivatives								
Equity contract	303	–	–	–	–	–	–	–
Equity index swaps	–	–	4	–	–	–	4	–
Stock index futures contracts	110	554	529	1	110	554	529	1
Stock index option contracts	43	12	–	–	43	12	–	–
Currency derivatives								
Forward foreign exchange contracts	2,454	1,083	798	662	2,435	1,083	786	649
Bond futures contracts	9	3	4	21	9	3	4	21
	4,805	2,423	2,871	822	4,429	1,652	2,796	672
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	1,227	–	1,251	19	–	–	–	–
Currency derivatives								
Currency swap contracts	143	170	233	94	–	–	–	–
	1,370	170	1,484	113	–	–	–	–
TOTAL	6,175	2,593	4,355	935	4,429	1,652	2,796	672

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.

(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									
	2012					2011				
	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	27,363	1,013	1,004	9,614	15,732	20,726	1,601	1,011	7,000	11,114
Interest rate futures contracts	999	–	–	999	–	3,489	–	843	2,646	–
Equity derivatives										
Equity contract	1,022	–	–	1,022	–	–	–	–	–	–
Equity index swaps	–	–	–	–	–	508	508	–	–	–
Stock index futures contracts	41,380	41,380	–	–	–	37,154	37,154	–	–	–
Stock index option contracts	8,973	8,973	–	–	–	–	–	–	–	–
Currency derivatives										
Forward foreign exchange contracts	168,477	158,593	1,897	7,987	–	172,465	156,340	1,344	14,781	–
Bond futures contracts	9,799	9,799	–	–	–	11,638	11,638	–	–	–
	258,013	219,758	2,901	19,622	15,732	245,980	207,241	3,198	24,427	11,114
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	16,786	1,532	2,123	9,966	3,165	21,418	1,800	3,827	11,767	4,024
Currency derivatives										
Currency swap contracts	17,465	1,826	6,582	9,057	–	16,503	927	6,244	9,332	–
	34,251	3,358	8,705	19,023	3,165	37,921	2,727	10,071	21,099	4,024
TOTAL	292,264	223,116	11,606	38,645	18,897	283,901	209,968	13,269	45,526	15,138

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

	Fund – Notional amounts with remaining life of									
	2012					2011				
	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	**14,532**	**-**	**1,000**	**1,132**	**12,400**	13,400	-	1,000	2,000	10,400
Interest rate futures contracts	**999**	**-**	**-**	**999**	**-**	3,489	-	843	2,646	-
Equity derivatives										
Equity index swaps	**-**	**-**	**-**	**-**	**-**	508	508	-	-	-
Stock index futures contracts	**41,380**	**41,380**	**-**	**-**	**-**	37,154	37,154	-	-	-
Stock index option contracts	**8,973**	**8,973**	**-**	**-**	**-**	-	-	-	-	-
Currency derivatives										
Forward foreign exchange contracts	**164,986**	**156,874**	**1,897**	**6,215**	**-**	164,575	153,175	1,344	10,056	-
Bond futures contracts	**9,799**	**9,799**	**-**	**-**	**-**	11,638	11,638	-	-	-
TOTAL	**240,669**	**217,026**	**2,897**	**8,346**	**12,400**	230,764	202,475	3,187	14,702	10,400

9 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Fund	
	2012	2011	**2012**	2011
At fair value				
Debt securities				
Treasury bills and commercial paper				
Listed outside Hong Kong	**4,649**	18,036	**4,649**	18,036
Unlisted	**775,424**	714,828	**775,424**	714,828
Certificates of deposit				
Unlisted	**35,729**	–	**35,729**	–
Other debt securities				
Listed outside Hong Kong	**598,138**	561,088	**596,294**	558,932
Unlisted	**646,186**	559,623	**636,439**	552,599
Total debt securities	**2,060,126**	1,853,575	**2,048,535**	1,844,395
Equity securities				
Listed in Hong Kong	**147,971**	120,580	**147,971**	120,580
Listed outside Hong Kong	**218,404**	183,717	**218,404**	183,717
Unlisted	**66,416**	54,525	**64,886**	54,525
Total equity securities	**432,791**	358,822	**431,261**	358,822
TOTAL	**2,492,917**	2,212,397	**2,479,796**	2,203,217

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

10 AVAILABLE-FOR-SALE SECURITIES

	Group		Fund	
	2012	2011	**2012**	2011
Debt securities, at fair value				
Listed outside Hong Kong	**334**	–	**–**	–
Unlisted	**1,890**	294	**–**	–
	2,224	294	**–**	–
Equity securities				
Listed in Hong Kong, at fair value	**3,318**	2,009	**–**	–
Unlisted, at cost	**493**	493	**493**	493
	3,811	2,502	**493**	493
Investment funds, at fair value				
Unlisted	**37,573**	20,668	**–**	–
TOTAL	**43,608**	23,464	**493**	493

The Group's investment in unlisted equity securities as at 31 December 2012 represents a holding of 4,285 shares (2011: 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	
	2012	2011	**2012**	2011
At amortised cost				
Debt securities				
Listed in Hong Kong	**2,533**	1,496	**–**	–
Listed outside Hong Kong	**2,953**	3,030	**–**	–
Unlisted	**3,838**	3,839	**–**	–
TOTAL	**9,324**	8,365	**–**	–

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

12 LOAN PORTFOLIO

	Group		Fund	
	2012	2011	**2012**	2011
Mortgage loans, at amortised cost	**24,886**	31,812	**–**	–
Non-mortgage loans, at amortised cost	**1,013**	1,332	**–**	–
Allowance for loan impairment	**(4)**	(8)	**–**	–
TOTAL	**25,895**	33,136	**–**	–

13 GOLD

	Group and Fund	
	2012	2011
Gold, at market value		
66,798 ounces (2011: 66,798 ounces)	**862**	817

14 OTHER ASSETS

	Group		Fund	
	2012	2011	**2012**	2011
Interest and dividends receivable	**8,591**	9,630	**8,090**	9,120
Unsettled sales and redemption of securities	**36,442**	5,565	**36,442**	5,565
Prepayments, receivables and other assets	**3,526**	7,877	**3,138**	7,391
Staff housing loans	**179**	166	**179**	166
Loan to the International Monetary Fund	**483**	284	**483**	284
Deferred tax assets	**92**	–	**–**	–
TOTAL	**49,313**	23,522	**48,332**	22,526

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

15 INVESTMENTS IN SUBSIDIARIES

	Fund	
	2012	2011
Unlisted shares, at cost	**2,145**	2,145
Loans to subsidiaries	**53,554**	31,133
TOTAL	**55,699**	33,278

The following is a list of the principal subsidiaries as at 31 December 2012:

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%
Stratosphere Finance Company Limited	Hong Kong	Investment holding	HK$1	100%

Loans to subsidiaries which principally hold investments including properties are unsecured, interest-free and repayable on demand.

The financial statements of these subsidiaries have been audited by firms other than the Audit Commission. The aggregate net assets and income attributed to these companies not audited by the Audit Commission amounted to 2.78% and 4.94% of the Group's respective items.

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

16 INTERESTS IN ASSOCIATE AND JOINT VENTURES

	Group		Fund	
	2012	2011	**2012**	2011
Associate				
Unlisted shares, at cost	**–**	–	**–**	–
Share of post-acquisition reserves	**57**	48	**–**	–
	57	48	**–**	–
Joint ventures				
Unlisted shares, at cost	**–**	120	**–**	–
Due from joint ventures	**5,088**	3,140	**–**	–
Share of post-acquisition reserves	**110**	(66)	**–**	–
Currency translation differences	**(13)**	22	**–**	–
	5,185	3,216	**–**	–
TOTAL	**5,242**	3,264	**–**	–

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% (2011: 50%) equity interest.

The Group holds investments in joint ventures through its subsidiaries, the HKMC and Real Gate Investment Company Limited (RG). At the beginning of the year, the HKMC held interest in one joint venture and RG held interest in two joint ventures. During the year:

– the HKMC disposed of its interest in the joint venture;

– RG entered into three more joint ventures with principal activities in holding overseas investment properties; and

– RG increased its interest in one of the joint ventures from 74% to 98% for a total consideration of HK$781 million, satisfied in cash. The entity became a subsidiary of RG. The transaction was accounted for as purchase of assets and assumption of liabilities and no goodwill was recognised. The major assets of the entity at the date it became a subsidiary of RG included an investment property with fair value of HK$7,735 million and cash of HK$91 million, while its major liabilities consisted of bank loans of HK$4,165 million. Net cash outflow arising from the acquisition is analysed below:

Cash consideration	**781**
Less: Cash held by the acquired entity	**(91)**
Net cash outflow	**690**

At the end of 2012, the Group held equity interest ranging from 48% to 51% (2011: 51% to 74%) in four joint ventures, which are all incorporated outside Hong Kong.

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

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

	Group	
	2012	2011
Current assets	**392**	442
Non-current assets	**10,996**	8,241
Current liabilities	**252**	300
Non-current liabilities	**5,951**	5,167
Share of income	**1,253**	955
Share of expenses	**608**	867

17 INVESTMENT PROPERTIES

	Group		Fund	
	2012	2011	**2012**	2011
At fair value				
At 1 January	**3,126**	–	**–**	–
Additions	**12,926**	3,421	**–**	–
Change in fair value on revaluation	**(133)**	(134)	**–**	–
Exchange difference	**461**	(161)	**–**	–
At 31 December	**16,380**	3,126	**–**	–

The Group's investment properties were revalued at 31 December 2012 by independent professionally qualified valuers on an open market value basis. The valuers have valued such properties based on market and income approach with reference to comparable market evidence. The market value which is considered as the fair value of each investment property reflects, among other things, rental income from current leases and assumptions about rental income from future leases in light of the current market conditions. The fair value also reflects, on a similar basis, any cash outflows that could be expected in respect of the property.

The Group's investment properties as at 31 December 2011 were revalued 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.

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

The carrying amount of the Group's investment properties is analysed as follows:

	Group		Fund	
	2012	2011	**2012**	2011
Held outside Hong Kong				
on freehold	**8,908**	3,126	**–**	–
on long-term lease (over 50 years)	**7,472**	–	**–**	–
TOTAL	**16,380**	3,126	**–**	–

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	
	2012	2011	**2012**	2011
Gross rental income	**386**	134	–	–
Direct expenses	**(23)**	(1)	**–**	–
Net rental income	**363**	133	**–**	–

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

	Group		Fund	
	2012	2011	**2012**	2011
Within one year	**954**	184	**–**	–
After one year but not later than five years	**3,782**	736	**–**	–
After five years but not later than ten years	**4,029**	920	**–**	–
After ten years but not later than fifteen years	**2,411**	635	**–**	–
After fifteen years but not later than twenty years	**14**	–	**–**	–
TOTAL	**11,190**	2,475	**–**	–

At 31 December 2012, investment properties with a fair value of HK$16,380 million (2011: HK$3,126 million) 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 2011	3,852	761	262	4,875
Additions	–	56	17	73
Disposals	–	(5)	–	(5)
At 31 December 2011	3,852	812	279	4,943
At 1 January 2012	**3,852**	**812**	**279**	**4,943**
Additions	**–**	**60**	**16**	**76**
Disposals	**–**	**(6)**	**–**	**(6)**
At 31 December 2012	**3,852**	**866**	**295**	**5,013**
Accumulated depreciation				
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
At 1 January 2012	**720**	**553**	**247**	**1,520**
Charge for the year	**89**	**64**	**7**	**160**
Written back on disposal	**–**	**(6)**	**–**	**(6)**
At 31 December 2012	**809**	**611**	**254**	**1,674**
Net book value				
At 31 December 2012	**3,043**	**255**	**41**	**3,339**
At 31 December 2011	3,132	259	32	3,423

(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 2011	3,843	268	262	4,373
Additions	–	30	17	47
Disposals	–	(3)	–	(3)
At 31 December 2011	3,843	295	279	4,417
At 1 January 2012	**3,843**	**295**	**279**	**4,417**
Additions	**–**	**43**	**16**	**59**
At 31 December 2012	**3,843**	**338**	**295**	**4,476**
Accumulated depreciation				
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
At 1 January 2012	**716**	**216**	**247**	**1,179**
Charge for the year	**88**	**26**	**7**	**121**
At 31 December 2012	**804**	**242**	**254**	**1,300**
Net book value				
At 31 December 2012	**3,039**	**96**	**41**	**3,176**
At 31 December 2011	3,127	79	32	3,238

(b) The net book value of premises comprises:

	Group		Fund	
	2012	2011	**2012**	2011
In Hong Kong				
Leasehold land and the building situated thereon (leasehold between 10 and 50 years)	**3,020**	3,109	**3,016**	3,104
Outside Hong Kong				
Freehold land and the building situated thereon	**23**	23	**23**	23
TOTAL	**3,043**	3,132	**3,039**	3,127

(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	
	2012	2011	**2012**	2011
Carrying amount	**289,837**	258,702	**9,934**	9,888
Reconciliation with face value:				
Hong Kong dollar face value	**291,675**	259,815	**9,997**	9,930
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$37,394 million**	US$33,310 million	**US$1,282 million**	US$1,273 million
Market exchange rate for translation into Hong Kong dollars	**US$1 = HK$7.75085**	US$1 = HK$7.7666	**US$1 = HK$7.75085**	US$1 = HK$7.7666
Carrying amount	**289,837**	258,702	**9,934**	9,888

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	
	2012	2011
At amortised cost		
Placements by central banks	–	24,547

22 PLACEMENTS BY FISCAL RESERVES

	Group and Fund	
	2012	2011
Placements with interest payable at a fixed rate determined annually		
General Revenue Account	**373,533**	342,235
Land Fund	**209,267**	198,140
Capital Works Reserve Fund	**92,103**	81,977
Civil Service Pension Reserve Fund	**25,742**	24,373
Disaster Relief Fund	**6**	9
Innovation and Technology Fund	**2,589**	3,067
Lotteries Fund	**10,200**	9,351
Capital Investment Fund	**1,211**	1,966
Loan Fund	**2,608**	2,246
	717,259	663,364
Placements with interest payable at market-based rates		
General Revenue Account	**277**	143
TOTAL	**717,536**	663,507

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 5.6% per annum for 2012 (2011: 6.0%).

(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	
	2012	2011
Placements with interest payable at a fixed rate[1] determined annually		
Research Endowment Fund	**25,538**	19,945
Bond Fund	**72,209**	50,944
Housing Authority	**34,862**	33,013
West Kowloon Cultural District Authority	**11,756**	11,133
Trading Funds	**5,028**	4,762
Community Care Fund	**5,454**	5,165
Elite Athletes Development Fund	**6,281**	–
Samaritan Fund	**6,050**	–
	167,178	124,962
Placements with interest payable at market-based rates		
Deposit Protection Scheme Fund	**735**	1,287
TOTAL	**167,913**	126,249

1 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 5.6% per annum for 2012 (2011: 6.0%).

24 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group		Fund	
	2012	2011	**2012**	2011
At fair value				
Exchange Fund Bills and Notes issued				
Exchange Fund Bills	**618,263**	585,916	**618,263**	585,916
Exchange Fund Notes	**72,721**	72,832	**72,721**	72,832
	690,984	658,748	**690,984**	658,748
Exchange Fund Bills held	**(2,770)**	(2,998)	**(2,500)**	(2,998)
TOTAL	**688,214**	655,750	**688,484**	655,750

(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			
	2012		2011		2012		2011	
	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	586,113	69,300	583,238	69,900	586,113	69,300	583,238	69,900
Issuance	1,864,764	16,400	1,824,878	16,400	1,864,764	16,400	1,824,878	16,400
Redemption	(1,832,604)	(17,000)	(1,822,003)	(17,000)	(1,832,604)	(17,000)	(1,822,003)	(17,000)
Nominal value at 31 December	618,273	68,700	586,113	69,300	618,273	68,700	586,113	69,300
Long positions held by Financial Stability and Other Activities segment								
Nominal value at 31 December	(2,770)	–	(3,000)	–	(2,500)	–	(3,000)	–
Total nominal value	615,503	68,700	583,113	69,300	615,773	68,700	583,113	69,300
Carrying amount, at fair value	615,493	72,721	582,918	72,832	615,763	72,721	582,918	72,832
Difference	10	(4,021)	195	(3,532)	10	(4,021)	195	(3,532)

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

25 BANK LOANS

	Group		Fund	
	2012	2011	2012	2011
At amortised cost				
Bank loans repayable:				
After two years but not later than five years	6,120	1,876	–	–
After five years but not later than ten years	3,130	–	–	–
	9,250	1,876	–	–

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

26 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2012	2011	**2012**	2011
At amortised cost				
Mortgage-backed securities issued	**214**	367	**–**	–

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	
	2012	2011	**2012**	2011
Total mortgage-backed securities issued				
Nominal value at 1 January	**367**	1,506	**–**	–
Redemption	**(153)**	(1,139)	**–**	–
Nominal value at 31 December	**214**	367	**–**	–
Carrying amount	**214**	367	**–**	–
Difference	**–**	–	**–**	–

27 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2012	2011	**2012**	2011
Debt securities issued, carried at amortised cost	**3,392**	3,697	**–**	–
Debt securities issued, designated as fair value hedge	**32,633**	36,469	**–**	–
Debt securities issued, designated at fair value	**340**	892	**–**	–
TOTAL	**36,365**	41,058	**–**	–

(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	
	2012	2011	**2012**	2011
Total debt securities issued				
Nominal value at 1 January	**40,273**	38,443	**–**	–
Issuance	**19,098**	28,549	**–**	–
Redemption	**(24,149)**	(26,719)	**–**	–
Foreign currency translation difference	**7**	–	**–**	–
Nominal value at 31 December	**35,229**	40,273	**–**	–
Carrying amount	**36,365**	41,058	**–**	–
Difference	**(1,136)**	(785)	**–**	–
Debt securities issued, designated at fair value				
Nominal value	**389**	1,459	**–**	–
Carrying amount, at fair value	**340**	892	**–**	–
Difference	**49**	567	**–**	–

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	
	2012	2011	**2012**	2011
Unsettled purchases of securities	**25,407**	31,467	**25,407**	31,467
Accrued charges and other liabilities	**6,889**	6,433	**388**	376
Interest payable	**491**	524	**211**	276
Tax payable	**108**	136	**–**	–
Deferred tax liabilities	**149**	79	**–**	–
TOTAL	**33,044**	38,639	**26,006**	32,119

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

29 EQUITY

	Group		Fund	
	2012	2011	**2012**	2011
Attributable to owner of the Fund				
Accumulated surplus				
At 1 January	**575,968**	597,553	**567,914**	591,503
Surplus/(Deficit) for the year	**61,300**	(21,585)	**55,970**	(23,589)
At 31 December	**637,268**	575,968	**623,884**	567,914
Revaluation reserve				
At 1 January	**1,744**	2,078	**–**	–
Fair value changes on available-for-sale securities:				
– revaluation	**2,259**	(284)	**–**	–
– realisation on disposal	**(38)**	(51)	**–**	–
– tax effect	**(53)**	(10)	**–**	–
Fair value changes on cash flow hedges:				
– revaluation	**–**	3	**–**	–
– transferred to income and expenditure account	**6**	10	**–**	–
– tax effect	**(1)**	(2)	**–**	–
	2,173	(334)	**–**	–
At 31 December	**3,917**	1,744	**–**	–
Translation reserve				
At 1 January	**42**	41	**–**	–
Currency translation differences:				
– subsidiaries and joint ventures	**1**	1	**–**	–
– reserve released on disposal of a joint venture	**(7)**	–	**–**	–
	(6)	1	**–**	–
At 31 December	**36**	42	**–**	–
	641,221	577,754	**623,884**	567,914
Non-controlling interests				
At 1 January	**282**	272	**–**	–
Surplus for the year	**39**	15	**–**	–
Other comprehensive income for the year	**–**	1	**–**	–
Capital injection by non-controlling interests	**167**	4	**–**	–
Dividends paid to non-controlling interests	**(10)**	(10)	**–**	–
At 31 December	**478**	282	**–**	–
TOTAL	**641,699**	578,036	**623,884**	567,914

(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	
	2012	2011	**2012**	2011
Cash and money at call	**51,353**	60,564	**49,978**	60,138
Placements with banks and other financial institutions	**139,068**	171,507	**137,930**	161,529
Treasury bills and commercial paper	**117,392**	22,720	**117,392**	22,720
TOTAL	**307,813**	254,791	**305,300**	244,387

Reconciliation with the balance sheet

		Group		Fund	
	Note	**2012**	2011	**2012**	2011
Amounts shown in the balance sheet					
Cash and money at call	6	**51,353**	60,564	**49,978**	60,138
Placements with banks and other financial institutions	7	**148,042**	171,805	**138,332**	161,529
Financial assets designated at fair value					
Treasury bills and commercial paper	9	**780,073**	732,864	**780,073**	732,864
		979,468	965,233	**968,383**	954,531
Less: Amounts with original maturity beyond 3 months		**(671,655)**	(710,442)	**(663,083)**	(710,144)
Cash and cash equivalents in the statement of cash flows		**307,813**	254,791	**305,300**	244,387

(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	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
Income								
Interest and dividend income	**4,708**	5,515	**22,196**	23,920	**1,316**	1,186	**28,220**	30,621
Investment gains/(losses)	**(523)**	10,914	**83,093**	(16,217)	**129**	126	**82,699**	(5,177)
Other income	**–**	–	**40**	21	**733**	896	**773**	917
	4,185	16,429	**105,329**	7,724	**2,178**	2,208	**111,692**	26,361
Expenditure								
Interest expense	**1,168**	1,667	**45,890**	42,761	**361**	204	**47,419**	44,632
Other expenses	**811**	774	**947**	858	**1,834**	1,571	**3,592**	3,203
	1,979	2,441	**46,837**	43,619	**2,195**	1,775	**51,011**	47,835
Surplus/(Deficit) before share of profit of associate and joint ventures	**2,206**	13,988	**58,492**	(35,895)	**(17)**	433	**60,681**	(21,474)
Share of profit of associate and joint ventures, net of tax	**–**	–	**642**	85	**12**	4	**654**	89
Gain from disposal of a joint venture	**–**	–	**–**	–	**7**	–	**7**	–
Surplus/(Deficit) before taxation	**2,206**	13,988	**59,134**	(35,810)	**2**	437	**61,342**	(21,385)

(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	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011	**2012**	2011
Assets										
Backing Assets										
Investment in designated US dollar assets	**1,317,605**	1,183,554	**–**	–	**–**	–	**–**	–	**1,317,605**	1,183,554
Interest receivable on designated US dollar assets	**1,427**	1,728	**–**	–	**–**	–	**–**	–	**1,427**	1,728
Net accounts receivable/(payable)	**(3,487)**	(13,330)	**–**	–	**–**	–	**3,487**	17,447	**–**	4,117
Other investments	**–**	–	**1,416,972**	1,220,734	**61,816**	115,648	**(2,770)**	(2,998)	**1,476,018**	1,333,384
Other assets	**–**	–	**19,610**	17,481	**6,375**	6,502	**31,415**	1,472	**57,400**	25,455
TOTAL ASSETS	**1,315,545**	1,171,952	**1,436,582**	1,238,215	**68,191**	122,150	**32,132**	15,921	**2,852,450**	2,548,238
Liabilities										
Monetary Base										
Certificates of Indebtedness	**289,837**	258,702	**–**	–	**–**	–	**–**	–	**289,837**	258,702
Government-issued currency notes and coins in circulation	**9,934**	9,888	**–**	–	**–**	–	**–**	–	**9,934**	9,888
Balance of the banking system	**255,851**	148,684	**–**	–	**–**	–	**–**	–	**255,851**	148,684
Exchange Fund Bills and Notes issued	**690,984**	658,748	**–**	–	**–**	–	**(2,770)**	(2,998)	**688,214**	655,750
Interest payable on Exchange Fund Notes	**211**	276	**–**	–	**–**	–	**–**	–	**211**	276
Net accounts (receivable)/payable	**(31,415)**	(1,471)	**–**	–	**–**	–	**31,415**	1,472	**–**	1
Mortgage-backed securities issued	**–**	–	**–**	–	**214**	367	**–**	–	**214**	367
Other debt securities issued	**–**	–	**–**	–	**36,365**	41,058	**–**	–	**36,365**	41,058
Placements by banks and other financial institutions	**–**	–	**–**	–	**–**	24,547	**–**	–	**–**	24,547
Bank loans	**–**	–	**9,250**	1,876	**–**	–	**–**	–	**9,250**	1,876
Placements by Fiscal Reserves	**–**	–	**717,536**	663,507	**–**	–	**–**	–	**717,536**	663,507
Placements by HKSAR government funds and statutory bodies	**–**	–	**167,178**	124,962	**735**	1,287	**–**	–	**167,913**	126,249
Other liabilities	**–**	–	**25,035**	14,977	**6,904**	6,873	**3,487**	17,447	**35,426**	39,297
TOTAL LIABILITIES	**1,215,402**	1,074,827	**918,999**	805,322	**44,218**	74,132	**32,132**	15,921	**2,210,751**	1,970,202

(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 108.07% as at 31 December 2012 (2011: 108.92%).

(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 2012, deductions from the Backing Assets comprised "other liabilities" of HK$3,487 million (2011: HK$17,447 million).

The Monetary Base is also presented on a net basis. As at 31 December 2012, deductions from the Monetary Base comprising "other assets" of HK$31,415 million (2011: HK$1,472 million) consisted of two components:

– 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 (2011: HK$29 million) and revaluation gains of HK$1,803 million (2011: HK$1,443 million) on these interest rate swaps are included in "net accounts (receivable)/payable" to reduce the Monetary Base.

– EFBN issued on tender date but not yet settled of HK$29,583 million (2011: Nil) are included in "net accounts (receivable)/payable" to reduce the Monetary Base.

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

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

32 PLEDGED ASSETS

Assets are pledged as margin for stock index and bond futures contracts as well as securities lending agreements, 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	**2012**	2011	**2012**	2011
Secured liabilities					
Stock index futures contracts – notional amount	8(b)	**41,380**	37,154	**41,380**	37,154
Bond futures contracts – notional amount	8(b)	**9,799**	11,638	**9,799**	11,638
Interest rate futures contracts – notional amount	8(b)	**999**	3,489	**999**	3,489
Bank loans	25	**9,250**	1,876	**–**	–
Mortgage-backed securities issued	26	**214**	367	**–**	–
Assets pledged					
Financial assets designated at fair value		**4,726**	5,157	**4,726**	5,157
Investment properties		**16,380**	3,126	**–**	–
Mortgage loans		**210**	529	**–**	–

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	
	2012	2011	**2012**	2011
Contracted for	**38**	1	**34**	1
Authorised but not yet contracted for	**276**	165	**168**	151
	314	166	**202**	152

(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 2012, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK$4,050 million equivalent (2011: HK$4,054 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$483 million equivalent with a repayment term of five years (2011: HK$284 million equivalent).

(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 (2011: HK$120 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 2012, there was no outstanding balance due from the HKDPB under this facility (2011: 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 (2011: HK$30 billion) at prevailing market interest rates. As at 31 December 2012, there was no outstanding balance due from the HKMC under this facility (2011: 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$44,567 million equivalent (2011: HK$44,658 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2012, there was no outstanding transaction with any central bank under this arrangement (2011: 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 2012, there had been no request to activate the CMIM.

(g) Bilateral swap agreement

The People's Bank of China (PBoC) and the HKMA signed a bilateral swap agreement in November 2011 for a term of three years. This currency swap agreement, with a size of RMB400 billion/HK$490 billion, helps facilitate the development of offshore renminbi business in Hong Kong. There was no outstanding transaction with the PBoC at 31 December 2012 (2011: RMB20 billion).

(h) Investment commitments

The Group's subsidiaries with principal activities for holding investment including properties had investment commitment of HK$63,813 million equivalent as at 31 December 2012 (2011: HK$56,024 million equivalent).

(i) Lease commitments

As at 31 December 2012, the total future minimum lease payments payable under non-cancellable operating leases of premises were as follows:

	Group		Fund	
	2012	2011	**2012**	2011
Within one year	**57**	56	**43**	42
After one year but not later than five years	**141**	52	**128**	25
TOTAL	**198**	108	**171**	67

(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. During the year, the Fund had contributed HK$14 million to FDRCL (2011: HK$4 million). The outstanding commitment of the Fund to contribute to FDRCL as at 31 December 2012 was HK$28 million (2011: HK$42 million).

34 CONTINGENT LIABILITIES

As at 31 December 2012, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK$191 million equivalent (2011: 16.1 million Special Drawing Rights or HK$192 million equivalent), in respect of the uncalled portion of its 4,285 shares (2011: 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$127 million (2011: HK$118 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 of the Fund while the Risk Management and Compliance Division (RMC Division), which is independent of the Reserves Management Department, carries out the risk management activities 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:

	2012	2011
Asset type		
Bonds	**75%**	75%
Equities and related investments	**25%**	25%
	100%	100%
Currency		
US dollar and Hong Kong dollar	**79%**	81%
Others[1]	**21%**	19%
	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 RMC Division is responsible for risk management and compliance monitoring regarding the investments of the Fund. The RMC Division 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 the Reserves Management Department, the Monetary Management Department, the Research Department and the RMC Division of the HKMA.

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 conducts 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 both individual and group levels 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 default risks 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 Division 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 of the financial assets of the Group and the Fund are equal to their carry amounts. The maximum exposures to credit risk of off-balance sheet exposures are as follows:

		Group		Fund	
	Note	**2012**	2011	**2012**	2011
Risk in force – mortgage insurance	36.6	**16,615**	16,624	**–**	–
Risk in force – other guarantee and insurance		**1,152**	875	**–**	–
Loan commitments and other credit related commitments		**264,533**	257,119	**230,720**	231,095
TOTAL		**282,300**	274,618	**230,720**	231,095

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. As at 31 December 2012, approximately 90% (2011: 92%) of the debt securities held by the Group were rated "double-A" or above by both Moody's and Standard & Poor's. The credit quality of major financial assets is analysed below:

	Group		Fund	
	2012	2011	**2012**	2011
Cash and money at call, placements with banks and other financial institutions, by credit rating[1]				
AAA	**708**	697	**708**	697
AA- to AA+	**109,257**	99,452	**108,360**	98,127
A- to A+	**85,346**	105,714	**76,273**	97,336
Lower than A- or un-rated[2]	**4,084**	26,506	**2,969**	25,507
	199,395	232,369	**188,310**	221,667
Debt securities, by credit rating[1]				
AAA	**493,163**	531,990	**490,040**	529,543
AA- to AA+	**1,361,834**	1,172,266	**1,355,254**	1,166,838
A- to A+	**46,202**	9,432	**44,356**	8,648
Lower than A- or un-rated[2]	**170,475**	148,546	**158,885**	139,366
	2,071,674	1,862,234	**2,048,535**	1,844,395
Loan portfolio				
Neither past due nor impaired (note 36.3.3(a))	**25,518**	32,707	**–**	–
Past due but not impaired (note 36.3.3(b))	**379**	432	**–**	–
Impaired (note 36.3.3(c))	**2**	5	**–**	–
Allowance for loan impairment	**(4)**	(8)	**–**	–
	25,895	33,136	**–**	–
TOTAL	**2,296,964**	2,127,739	**2,236,845**	2,066,062

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

[2] These included mainly balances 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	
	2012	2011	**2012**	2011
Grades				
1 to 3	**25,500**	32,693	**–**	–
4	**–**	–	**–**	–
5	**18**	14	**–**	–
TOTAL	**25,518**	32,707	**–**	–

(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	
	2012	2011	**2012**	2011
Loans that were past due				
90 days or less	**376**	430	**–**	–
91 to 180 days	**–**	1	**–**	–
over 180 days	**3**	1	**–**	–
TOTAL	**379**	432	**–**	–
Fair value of collateral and other credit enhancements	**2,531**	2,358	**–**	–

(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 2012, the fair value of related collateral held and credit enhancement was HK$8 million (2011: HK$14 million).

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

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 by industry groups is analysed below:

	Group		Fund	
	2012	2011	**2012**	2011
Governments and government agencies[1]	**1,755,383**	1,681,766	**1,754,458**	1,680,862
Supra-nationals	**171,433**	115,688	**171,411**	115,665
States, provinces and public-sector entities[2]	**176,283**	175,424	**204,720**	204,530
Financial institutions	**221,984**	188,087	**203,944**	171,892
Others[3]	**314,566**	272,409	**239,326**	180,663
TOTAL	**2,639,649**	2,433,374	**2,573,859**	2,353,612

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 values 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 and valuation. 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 Division 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.

The Fund's investment in less liquid assets (e.g. real estates) is grouped under the Long-Term Growth Portfolio. The investment risks of the less liquid assets are controlled at the aggregate level through such measures as asset class approval, allocation limit, country concentration limit and aggregate counterparty exposure. As determined by the EFAC, the maximum size of the Long-Term Growth Portfolio is at one-third of the Accumulated Surplus of the Exchange Fund.

(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 – 2012 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	50,976	–	–	–	–	–	50,976	377
Placements with banks and other financial institutions	137,051	5,941	5,050	–	–	–	148,042	–
Financial assets designated at fair value	230,737	346,738	478,597	568,608	250,646	170,705	2,046,031	446,886
Available-for-sale securities	868	703	653	–	–	–	2,224	41,384
Held-to-maturity securities	144	50	1,563	3,804	3,763	–	9,324	–
Loan portfolio	24,657	1,169	37	24	8	–	25,895	–
Interest-bearing assets	444,433	354,601	485,900	572,436	254,417	170,705	2,282,492	
Liabilities								
Placements by Fiscal Reserves with interest payable at market-based rates[1]	277	–	–	–	–	–	277	–
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates[1]	735	–	–	–	–	–	735	–
Exchange Fund Bills and Notes issued	171,980	282,947	176,467	39,967	9,694	7,159	688,214	–
Bank loans	9,250	–	–	–	–	–	9,250	–
Mortgage-backed securities issued	214	–	–	–	–	–	214	–
Other debt securities issued	5,973	12,124	2,136	12,118	3,270	744	36,365	–
Interest-bearing liabilities	188,429	295,071	178,603	52,085	12,964	7,903	735,055	
Net interest-bearing assets/(liabilities)	256,004	59,530	307,297	520,351	241,453	162,802	1,547,437	
Interest rate derivatives (net position, notional amounts)	1,272	(23,374)	3,119	6,441	5,791	6,722	(29)	
Interest rate sensitivity gap	257,276	36,156	310,416	526,792	247,244	169,524	1,547,408	

[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 2012, such placements amounted to HK$884,437 million (2011: HK$788,326 million).

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

	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 2012, such placements amounted to HK$884,437 million (2011: HK$788,326 million).

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

	Fund – 2012 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	49,788	–	–	–	–	–	49,788	190
Placements with banks and other financial institutions	136,000	2,332	–	–	–	–	138,332	–
Financial assets designated at fair value	229,541	345,753	478,310	568,065	249,345	170,705	2,041,719	438,077
Interest-bearing assets	415,329	348,085	478,310	568,065	249,345	170,705	2,229,839	
Liabilities								
Placements by Fiscal Reserves with interest payable at market-based rates[1]	277	–	–	–	–	–	277	–
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates[1]	735	–	–	–	–	–	735	–
Exchange Fund Bills and Notes issued	171,980	283,217	176,467	39,967	9,694	7,159	688,484	–
Interest-bearing liabilities	172,992	283,217	176,467	39,967	9,694	7,159	689,496	
Net interest-bearing assets/(liabilities)	242,337	64,868	301,843	528,098	239,651	163,546	1,540,343	
Interest rate derivatives (net position, notional amounts)	–	(14,400)	1,000	1,000	6,400	6,000	–	
Interest rate sensitivity gap	242,337	50,468	302,843	529,098	246,051	169,546	1,540,343	

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 2012, such placements amounted to HK$884,437 million (2011: HK$788,326 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 2012, such placements amounted to HK$884,437 million (2011: HK$788,326 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			
	2012		2011	
	Assets (in HK$ billion)	**Liabilities (in HK$ billion)**	Assets (in HK$ billion)	Liabilities (in HK$ billion)
Hong Kong dollar	**228.4**	**1,854.5**	216.0	1,649.1
US dollar	**2,143.1**	**334.6**	1,970.4	315.1
	2,371.5	**2,189.1**	2,186.4	1,964.2
Others[1]	**481.0**	**21.7**	361.8	6.0
TOTAL	**2,852.5**	**2,210.8**	2,548.2	1,970.2

	Fund			
	2012		2011	
	Assets (in HK$ billion)	**Liabilities (in HK$ billion)**	Assets (in HK$ billion)	Liabilities (in HK$ billion)
Hong Kong dollar	**193.3**	**1,830.3**	186.4	1,619.2
US dollar	**2,122.1**	**323.6**	1,945.6	299.7
	2,315.4	**2,153.9**	2,132.0	1,918.9
Others[1]	**465.7**	**3.3**	356.0	1.2
TOTAL	**2,781.1**	**2,157.2**	2,488.0	1,920.1

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

(c) Equity price risk

As at 31 December 2012 and 2011, 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	
	2012	2011
Value-at-Risk		
At 31 December[1]	**21,059**	40,224
During the year		
Average	**29,811**	35,358
Maximum	**39,827**	49,553
Minimum	**21,059**	27,374

[1] The amount represented 0.8% of the Fund's investments which were subject to VaR measurement as at 31 December 2012 (2011: 1.7%).

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 less liquid assets, 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. The liquidity risk for the Exchange Fund investment is monitored on an aggregate basis through appropriate portfolio mix with sufficient liquidity assets to balance off investments of less liquid assets. Compliance with these limits is monitored by the RMC Division 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 – 2012 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	289,837	–	–	–	–	–	289,837
Government-issued currency notes and coins in circulation	9,934	–	–	–	–	–	9,934
Balance of the banking system	255,851	–	–	–	–	–	255,851
Placements by Fiscal Reserves	717,536	–	–	–	–	–	717,536
Placements by HKSAR government funds and statutory bodies	83,763	–	–	67,150	17,000	–	167,913
Exchange Fund Bills and Notes issued	171,980	283,201	177,272	40,846	9,802	6,346	689,447
Bank loans	104	–	309	7,722	3,338	–	11,473
Mortgage-backed securities issued	4	210	–	–	–	–	214
Other debt securities issued	667	3,590	11,610	18,369	3,138	612	37,986
Other liabilities	31,529	314	5	–	–	–	31,848
Loan commitments and other credit related commitments	264,533	–	–	–	–	–	264,533
TOTAL	1,825,738	287,315	189,196	134,087	33,278	6,958	2,476,572
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
– on net basis	541	(90)	(243)	(891)	(218)	(4)	(905)
– on gross basis							
Total outflows	46,259	34,540	8,441	13,127	–	–	102,367
Total inflows	(45,632)	(34,176)	(8,507)	(13,477)	–	–	(101,792)
TOTAL	1,168	274	(309)	(1,241)	(218)	(4)	(330)

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

	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.)

	Fund – 2012 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	289,837	–	–	–	–	–	289,837
Government-issued currency notes and coins in circulation	9,934	–	–	–	–	–	9,934
Balance of the banking system	255,851	–	–	–	–	–	255,851
Placements by Fiscal Reserves	717,536	–	–	–	–	–	717,536
Placements by HKSAR government funds and statutory bodies	83,763	–	–	67,150	17,000	–	167,913
Exchange Fund Bills and Notes issued	171,980	283,471	177,272	40,846	9,802	6,346	689,717
Other liabilities	25,438	259	5	–	–	–	25,702
Loan commitments and other credit related commitments	230,720	–	–	–	–	–	230,720
TOTAL	1,785,059	283,730	177,277	107,996	26,802	6,346	2,387,210
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
– on net basis	569	–	–	–	–	–	569
– on gross basis							
Total outflows	44,917	32,000	969	3,147	–	–	81,033
Total inflows	(44,280)	(31,590)	(940)	(3,165)	–	–	(79,975)
TOTAL	1,206	410	29	(18)	–	–	1,627

(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

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 2012, the total risk-in-force was HK$16.6 billion (2011: HK$16.6 billion), of which HK$13.8 billion (2011: HK$14.1 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 resulting from inadequate or failed internal processes, people and systems or from external events. 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 are overly restrictive.

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 controls 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 are computed based on valuation methods and techniques generally recognised within the industry. 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, mortgage-backed securities and other debt securities issued that were not designated at fair value are shown below:

		Group			
		Carrying value		Fair value	
	Note	**2012**	2011	**2012**	2011
Financial assets					
Held-to-maturity securities	11	**9,324**	8,365	**9,836**	8,637
Financial liabilities					
Mortgage-backed securities issued	26	**214**	367	**214**	366
Other debt securities issued	27	**36,025**	40,166	**36,029**	40,172

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 2012 and 2011.

(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 – 2012			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Derivative financial instruments	**119**	**5,753**	**303**	**6,175**
Financial assets designated at fair value	**1,952,426**	**512,660**	**27,831**	**2,492,917**
Available-for-sale securities	**3,972**	**1,571**	**37,572**	**43,115**
	1,956,517	**519,984**	**65,706**	**2,542,207**
Liabilities				
Derivative financial instruments	**557**	**2,036**	**–**	**2,593**
Exchange Fund Bills and Notes issued	**–**	**688,214**	**–**	**688,214**
Other debt securities issued, designated at fair value	**–**	**340**	**–**	**340**
	557	**690,590**	**–**	**691,147**

	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

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

	Fund – 2012			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Derivative financial instruments	**119**	**4,310**	**–**	**4,429**
Financial assets designated at fair value	**1,952,426**	**508,956**	**18,414**	**2,479,796**
	1,952,545	**513,266**	**18,414**	**2,484,225**
Liabilities				
Derivative financial instruments	**557**	**1,095**	**–**	**1,652**
Exchange Fund Bills and Notes issued	**–**	**688,484**	**–**	**688,484**
	557	**689,579**	**–**	**690,136**

	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

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		Derivatives	
	2012	2011	**2012**	2011	**2012**	2011
At 1 January	**21,987**	20,774	**20,668**	8,929	**–**	–
Net gains/(losses) recognised in the income and expenditure account	**3,143**	(758)	**19**	–	**303**	–
Net gains/(losses) recognised in other comprehensive income	**–**	–	**1,901**	(392)	**–**	–
Purchases	**11,667**	10,912	**17,246**	13,160	**–**	–
Sales	**(7,675)**	(5,994)	**(2,262)**	(1,029)	**–**	–
Transfers into Level 3	**576**	268	**–**	–	**–**	–
Transfers out of Level 3	**(1,867)**	(3,215)	**–**	–	**–**	–
At 31 December	**27,831**	21,987	**37,572**	20,668	**303**	–
Net gains/(losses) recognised in the income and expenditure account relating to those assets held at the balance sheet date	**2,866**	(653)	**–**	–	**303**	–

	Fund			
	Designated at fair value		Available-for-sale	
	2012	2011	**2012**	2011
At 1 January	**16,509**	19,711	**–**	–
Net gains/(losses) recognised in the income and expenditure account	**1,671**	(786)	**–**	–
Purchases	**7,257**	6,210	**–**	–
Sales	**(5,745)**	(5,679)	**–**	–
Transfers into Level 3	**539**	268	**–**	–
Transfers out of Level 3	**(1,817)**	(3,215)	**–**	–
At 31 December	**18,414**	16,509	**–**	–
Net gains/(losses) recognised in the income and expenditure account relating to those assets held at the balance sheet date	**1,401**	(674)	**–**	–

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$2,813 million (2011: HK$2,199 million) and in other comprehensive income of HK$3,757 million (2011: HK$2,067 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 2012

Up to the date of issue of the financial statements, the HKICPA has issued a number of amendments and new standards which are not yet effective for the year ended 31 December 2012 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 and new standards 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
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
Annual Improvements to HKFRSs 2009 – 2011 Cycle	1 January 2013
Amendments to HKFRS 7, Financial Instruments: Disclosures – 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
Amendments to HKFRS 10, Consolidated Financial Statements, HKFRS 11, Joint Arrangements and HKFRS 12, Disclosure of Interests in Other Entities – Transition Guidance	1 January 2013
Amendments to HKFRS 10, Consolidated Financial Statements, HKFRS 12, Disclosure of Interests in Other Entities and HKAS 27 (2011), Separate Financial Statements – Investment entities	1 January 2014

39 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 8 April 2013.

Calendar of Events 2012

16 January

The HKMA and the UK Treasury announce the establishment of a private sector-led Hong Kong-London Forum to support the wider international use of renminbi.

20 January

The HKMA announces the introduction of a flexible version of enhanced measures applicable to the sale of investment products by authorized institutions (AIs) to private banking customers.

9 February

The calculation of the statutory liquidity ratio for AIs is adjusted to allow for the inclusion of more renminbi liquefiable assets.

29 February

The Banking (Amendment) Bill 2011 is passed by the Legislative Council (LegCo) to provide for the implementation of Basel III in Hong Kong.

30 March

The HKMA, Bank Negara Malaysia and Euroclear Bank jointly launch a pilot platform to enhance cross-border debt securities settlement efficiency and strengthen the capacity for debt securities issuance activities in the Asian region.

1 April

The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance and a guideline on the new legislative and regulatory requirements come into effect.

23 - 26 April

The HKMA holds overseas roadshows in Brazil and Chile to promote the one-stop offshore renminbi financial platform offered by Hong Kong.

A similar roadshow is held in Tokyo on 15 May.

22 May

AIs are allowed to set their own internal renminbi net open positions in consultation with the HKMA.

12 June

The HKMA, in close co-operation with the Securities and Futures Commission (SFC), provides guidance and clarification to facilitate the adoption of a "portfolio-based" approach in assessing the suitability of investment solicitation and recommendation for private banking customers.

14 June

The HKMA announces the replacement of the risk management limit with a renminbi liquidity ratio for monitoring AIs' renminbi liquidity positions.

15 June

The HKMA launches a renminbi liquidity facility to provide renminbi term funds to AIs participating in renminbi business in Hong Kong.

22 June

A $10 billion inflation-linked retail bond is issued under the Government Bond Programme and is subsequently listed on the Stock Exchange of Hong Kong on 25 June.

25 June

The operating hours of the renminbi Real Time Gross Settlement system in Hong Kong are extended to 15 hours, serving from 8:30 a.m. to 11:30 p.m.

The HKMA, Euroclear Bank and J.P. Morgan jointly launch a cross-border collateral management service.

28 June

Renminbi sovereign bonds totalling RMB2 billion are issued by the Ministry of Finance to overseas central banks and monetary authorities through the newly established HKMA CMU Central Bank Placement Co-ordinating Window.

29 June

The Ninth Supplement to the Closer Economic Partnership Arrangement is signed, allowing eligible Mainland subsidiaries of Hong Kong banks to offer custodian services for settlement funds of customers of securities companies and margin deposits on futures transactions; and allowing Hong Kong financial institutions, on a pilot basis, to set up consumer finance companies in Guangdong Province.

30 June

The Central Government announces a series of additional measures to bolster Hong Kong as the offshore renminbi business centre.

11 July

The HKMA and the SFC jointly publish the consultation conclusions on the proposed regulatory regime for the over-the-counter (OTC) derivatives market in Hong Kong, and a supplemental consultation paper on the proposed scope of the new and expanded regulated activities and the oversight of systematically important players.

Hong Kong and Australia jointly announce a private-sector led dialogue to consider how to capture opportunities in relation to the wider use of renminbi in trade and investment between Mainland China, Australia and Hong Kong.

1 August

AIs are allowed to provide renminbi services to personal customers who are non-Hong Kong residents.

14 September

The HKMA introduces further countercyclical measures on property mortgage loans.

3 December

The first phase of the local OTC derivatives trade repository is launched for supporting voluntary central clearing of OTC derivatives transactions.

12 December

The International Monetary Fund Staff Mission to Hong Kong reaffirms its long-standing support for the Linked Exchange Rate system and commends the Government's proactive policies to support growth and preserve financial stability, as the outcome of the Article IV Consultation conducted in November.

The Banking (Capital) (Amendment) Rules 2012, made under the Banking (Amendment) Ordinance 2012, is passed by LegCo to provide for the first-phase implementation of Basel III from 1 January 2013.

Annex and Tables

Annex Authorized Institutions and Local Representative Offices at 31 December 2012

LICENSED BANKS

Incorporated in Hong Kong

Bank of China (Hong Kong) Limited

Bank of East Asia, Limited (The)

China CITIC Bank International Limited (formerly known as CITIC Bank International Limited)

China Construction Bank (Asia) Corporation Limited

Chiyu Banking Corporation Limited

Chong Hing Bank Limited

CITIBANK (HONG KONG) 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

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

Deletion in 2012

MEVAS 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 Julius Baer & Co. Ltd.

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 Sarasin & Cie AG

BANK SINOPAC

Banque Privée Edmond de Rothschild SA

Barclays Bank PLC

BNP PARIBAS

BNP PARIBAS SECURITIES SERVICES

BNP PARIBAS WEALTH MANAGEMENT

BSI LTD
also known as:
BSI AG
BSI SA

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 Everbright Bank Co., Ltd #

China Merchants Bank Co., Ltd.

CHINA MINSHENG BANKING CORP., 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

CREDIT AGRICOLE CORPORATE AND INVESTMENT BANK

Crédit Agricole (Suisse) SA

Credit Suisse AG

DBS BANK LTD.

Deutsche Bank Aktiengesellschaft

Addition in 2012

Annex Authorized Institutions and Local Representative Offices at 31 December 2012 (continued)

DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main

E.Sun Commercial Bank, Ltd.

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.

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.

LLOYDS TSB BANK plc

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

Pictet & Cie (Europe) S.A. #

Portigon AG (formerly known as WestLB AG)

PT. Bank Negara Indonesia (Persero) Tbk.

Punjab National Bank

Raiffeisen Bank International AG #

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

Westpac Banking Corporation

Woori Bank

Addition in 2012

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

RBC Capital Markets (Hong Kong) 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 Investor Services Bank S.A.
(formerly known as
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

Addition in 2012

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

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

PrimeCredit Limited

PUBLIC FINANCE LIMITED

SHINHAN ASIA LIMITED

Sumitomo Mitsui Trust (Hong Kong) Limited (formerly known as The Sumitomo Trust Finance (H.K.) Limited)

Vietnam Finance Company Limited

Wing Hang Finance Company Limited

WOORI GLOBAL MARKETS ASIA LIMITED

Deletion in 2012

Hachijuni Asia Limited

ORIENT FIRST CAPITAL LIMITED

Incorporated outside Hong Kong

NIL

Annex Authorized Institutions and Local Representative Offices at 31 December 2012 (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 GUANGFA BANK CO., LTD.

CLEARSTREAM BANKING S.A.

Corporation Bank

Credit Industriel et Commercial

Credito Bergamasco S.p.A.

Dukascopy Bank SA #

Fiduciary Trust Company International

FIRST GULF BANK #

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)

Merrill Lynch Bank (Suisse) S.A.

Metropolitan Bank and Trust Company

MIG Banque SA #

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)

Ping An Bank Co., Ltd.
(formerly known as
Shenzhen Development Bank Co., Ltd.)

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

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 2012

China Everbright Bank Co., Ltd

CHINA MINSHENG BANKING CORPORATION LIMITED

LLOYDS TSB OFFSHORE LIMITED

Raiffeisen Bank International AG

Addition in 2012

Table A Major Economic Indicators

		2008	2009	2010	2011	**2012**
I.	**Gross Domestic Product**					
	Real GDP growth (%)	2.1	(2.5)	6.8	4.9	**1.4** [a]
	Nominal GDP growth (%)	3.4	(2.8)	7.1	9.0	**5.4** [a]
	Real growth of major expenditure components of GDP (%)					
	– Private consumption expenditure	1.9	0.8	6.3	9.0	**4.0** [a]
	– Government consumption expenditure	2.0	2.3	3.4	2.5	**3.7** [a]
	– Gross domestic fixed capital formation	1.4	(3.5)	7.7	10.2	**9.1** [a]
	of which					
	– Building and construction	6.8	(5.5)	5.7	15.5	**12.3** [a]
	– Machinery, equipment and computer software	0.0	(2.2)	6.5	12.2	**10.6** [a]
	– Exports	2.5	(10.1)	16.8	3.7	**1.3** [a]
	– Imports	2.2	(9.0)	17.4	4.6	**2.5** [a]
	GDP at current market prices (US$ billion)	219.3	214.0	228.7	248.7	**263.0** [a]
	Per capita GDP at current market prices (US$)	31,516	30,697	32,558	35,171	**36,763** [a]
II.	**External Trade (HK$ billion)**					
	Merchandise trade [b]					
	– Domestic exports of goods	101.7	76.4	82.2	89.6	**100.6** [a]
	– Re-exports of goods	2,742.3	2,418.3	2,979.1	3,321.8	**3,480.2** [a]
	– Imports of goods	3,024.1	2,703.0	3,395.1	3,848.2	**4,116.4** [a]
	– Merchandise trade balance	(180.1)	(208.2)	(333.8)	(436.8)	**(535.6)** [a]
	Services trade					
	– Exports of services	720.8	672.8	829.5	936.5	**985.8** [a]
	– Imports of services	367.0	340.3	399.2	439.7	**449.4** [a]
	– Services trade balance	353.8	332.5	430.3	496.8	**536.4** [a]
III.	**Fiscal Expenditure and Revenue (HK$ million, fiscal year)**					
	Total government expenditure [c]	315,112	292,525	301,360	364,037	**380,615** [a]
	Total government revenue	316,562	318,442	376,481	437,723	**445,506** [a]
	Consolidated surplus/deficit	1,450	25,917	75,121	73,686	**64,891** [a]
	Reserve balance as at end of fiscal year [d]	494,364	520,281	595,402	669,088	**733,979** [a]
IV.	**Prices (annual change, %)**					
	Consumer Price Index (A)	3.6	0.4	2.7	5.6	**3.6**
	Composite Consumer Price Index	4.3	0.5	2.4	5.3	**4.1**
	Trade Unit Value Indices					
	– Domestic exports	5.1	(0.2)	5.5	6.4	**2.5**
	– Re-exports	3.8	1.2	4.6	8.0	**3.4**
	– Imports	4.4	(0.1)	6.4	8.1	**3.3**
	Property Price Indices					
	– Residential flats	16.5	0.6	24.4	20.6	**13.2** [a]
	– Office premises	20.3	(9.7)	28.1	29.3	**11.9** [a]
	– Retail premises	11.4	0.5	33.2	27.3	**28.3** [a]
	– Flatted factory premises	18.2	(8.3)	31.5	35.4	**27.0** [a]

Table A Major Economic Indicators (continued)

		2008	2009	2010	2011	**2012**
V.	**Labour**					
	Labour force (annual change, %)	0.4	0.6	(0.8)	2.0	**2.2**
	Employment (annual change, %)	0.9	(1.2)	0.2	2.9	**2.4**
	Unemployment rate (annual average, %)	3.5	5.3	4.3	3.4	**3.3**
	Underemployment rate (annual average, %)	1.9	2.3	2.0	1.7	**1.5**
	Employment ('000)	3,509	3,468	3,474	3,576	**3,661**
VI.	**Money Supply (HK$ billion)**					
	HK$ money supply					
	– M1	491.1	671.2	730.1	794.7	**920.9**
	– M2 [e]	3,239.9	3,587.7	3,866.8	4,046.2	**4,537.4**
	– M3 [e]	3,261.3	3,604.8	3,878.2	4,055.4	**4,545.6**
	Total money supply					
	– M1	645.8	901.8	1,017.2	1,127.3	**1,377.4**
	– M2	6,268.1	6,602.3	7,136.3	8,057.5	**8,950.9**
	– M3	6,300.8	6,626.8	7,156.3	8,081.1	**8,971.3**
VII.	**Interest Rates (end of period, %)**					
	Three-month interbank rate	0.89	0.13	0.33	0.33	**0.50**
	Savings deposit	0.01	0.01	0.01	0.01	**0.01**
	One-month time deposit	0.04	0.01	0.01	0.01	**0.01**
	Banks' 'Best lending rate'	5.00	5.00	5.00	5.00	**5.00**
	Banks' 'Composite rate'	0.68	0.11	0.21	0.53	**0.32**
VIII.	**Exchange Rates (end of period)**					
	HK$/US$	7.751	7.756	7.775	7.766	**7.751**
	Trade-weighted Effective Exchange Rate Index (Jan 2010 = 100)	102.1	100.3	96.3	94.9	**94.2**
IX.	**Foreign Currency Reserve Assets (US$ billion)** [f]	182.5	255.8	268.7	285.4	**317.4**
X.	**Stock Market (end of period figures)**					
	Hang Seng Index	14,387	21,873	23,035	18,434	**22,657**
	Average price/earnings ratio	7.3	18.1	16.7	9.7	**10.5**
	Market capitalisation (HK$ billion)	10,253.6	17,769.3	20,942.3	17,452.7	**21,871.7**

(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					Retail Banks				
	2008 %	2009 %	2010 %	2011 %	**2012 %**	2008 %	2009 %	2010 %	2011 %	**2012 %**
Asset Quality [b]										
As % of total credit exposures [c]										
Total outstanding provisions/impairment allowances	0.66	0.63	0.47	0.42	**0.39**	0.64	0.56	0.39	0.33	**0.25**
Classified [d] exposures:										
– Gross	0.83	1.10	0.60	0.49	**0.40**	0.85	1.00	0.57	0.42	**0.34**
– Net of specific provisions/individual impairment allowances	0.39	0.71	0.34	0.28	**0.24**	0.42	0.66	0.33	0.24	**0.22**
– Net of all provisions/impairment allowances	0.17	0.47	0.14	0.07	**0.01**	0.21	0.44	0.18	0.09	**0.08**
As % of total loans										
Total outstanding provisions/impairment allowances	0.88	0.96	0.71	0.63	**0.60**	0.79	0.84	0.59	0.50	**0.39**
Classified [d] loans:										
– Gross	1.23	1.61	0.83	0.69	**0.58**	1.24	1.38	0.77	0.59	**0.47**
– Net of specific provisions/individual impairment allowances	0.75	1.07	0.46	0.40	**0.34**	0.84	0.92	0.45	0.34	**0.31**
– Net of all provisions/impairment allowances	0.35	0.65	0.13	0.05	**(0.02)**	0.45	0.54	0.18	0.09	**0.08**
Overdue > 3 months and rescheduled loans	0.69	0.92	0.58	0.47	**0.39**	0.67	0.88	0.60	0.49	**0.37**
Profitability										
Return on assets (operating profit)	0.59	0.73	0.82	0.81	**0.84**	1.02	1.09	1.11	1.11	**1.19**
Return on assets (post-tax profit)	0.49	0.64	0.76	0.72	**0.75**	0.88	0.97	1.01	1.02	**1.07**
Net interest margin	1.30	1.11	1.02	0.98	**1.08**	1.84	1.48	1.32	1.24	**1.36**
Cost-to-income ratio	55.6	58.0	58.0	55.4	**54.7**	45.3	49.7	49.9	46.6	**45.6**
Bad debt charge to total assets	0.18	0.13	0.05	0.07	**0.07**	0.18	0.11	0.03	0.04	**0.04**
Liquidity										
Loan to deposit ratio (all currencies)	54.2	51.5	61.6	66.9	**67.1**	47.3	46.3	52.8	55.3	**54.8**
Loan to deposit [e] ratio (Hong Kong dollar)	77.6	71.2	78.1	84.5	**79.8**	69.4	65.2	70.5	76.2	**72.3**

	Surveyed Institutions				
	2008 %	2009 %	2010 %	2011 %	**2012 %**
Asset Quality					
Delinquency ratio of residential mortgage loans	0.05	0.03	0.01	0.01	**0.02**
Credit card receivables					
– Delinquency ratio	0.34	0.34	0.20	0.19	**0.20**
– Charge-off ratio	2.72	3.71	1.91	1.49	**1.70**

	Locally Incorporated Licensed Banks				
	2008 %	2009 %	2010 %	2011 %	**2012 %**
Profitability					
Operating profit to shareholders' funds	14.0	14.8	14.2	15.5	**15.1**
Post-tax profit to shareholders' funds	12.1	13.2	12.9	14.2	**13.7**
Capital Adequacy					
Equity to assets ratio [b]	7.2	8.5	8.3	7.9	**8.5**

	All Locally Incorporated Authorized Institutions				
	2008 %	2009 %	2010 %	2011 %	**2012 %**
Capital Adequacy Ratio (Consolidated) [f]	14.7	16.8	15.8	15.8	**15.7**

(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).

Table C Authorized Institutions: Domicile and Parentage

		2008	2009	2010	2011	**2012**
Licensed Banks						
(i)	Incorporated in Hong Kong	23	23	23	23	**22**
(ii)	Incorporated outside Hong Kong	122	122	123	129	**133**
Total		145	145	146	152	**155**
Restricted Licence Banks						
(i)	Subsidiaries of licensed banks:					
	(a) incorporated in Hong Kong	0	1	1	1	**1**
	(b) incorporated outside Hong Kong	6	5	5	5	**6**
(ii)	Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	17	16	13	12	**12**
(iii)	Bank related	0	1	1	1	**1**
(iv)	Others	4	3	1	1	**1**
Total		27	26	21	20	**21**
Deposit-taking Companies						
(i)	Subsidiaries of licensed banks:					
	(a) incorporated in Hong Kong	7	7	6	6	**6**
	(b) incorporated outside Hong Kong	3	4	4	4	**3**
(ii)	Subsidiaries of foreign banks which are not licensed banks in Hong Kong	8	7	7	7	**7**
(iii)	Bank related	2	2	2	2	**2**
(iv)	Others	8	8	7	7	**6**
Total		28	28	26	26	**24**
All Authorized Institutions		200	199	193	198	**200**
Local Representative Offices		71	71	67	61	**60**

Table D Authorized Institutions: Region/Economy of Beneficial Ownership

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	08	09	10	11	**12**	08	09	10	11	**12**	08	09	10	11	**12**
Asia & Pacific															
Hong Kong	10	10	10	10	**9**	–	–	–	–	**–**	9	9	7	7	**7**
Australia	4	4	4	5	**5**	–	–	–	–	**–**	–	–	–	–	**–**
Mainland China	13	14	14	15	**17**	1	2	2	2	**2**	3	3	2	2	**2**
India	11	12	12	12	**12**	–	–	–	–	**–**	1	1	1	1	**1**
Indonesia	1	1	1	1	**1**	2	1	1	1	**1**	–	–	–	–	**–**
Japan	11	10	10	10	**10**	2	2	1	1	**1**	3	3	3	3	**2**
Malaysia	4	3	3	3	**3**	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	2	2	2	**2**
Singapore	4	4	5	5	**5**	–	–	–	–	**–**	–	–	–	–	**–**
South Korea	5	5	5	5	**5**	2	2	2	2	**2**	3	4	4	4	**4**
Taiwan	18	18	19	19	**19**	–	–	–	–	**–**	1	1	1	1	**1**
Thailand	1	1	1	1	**1**	4	4	4	3	**3**	–	–	–	–	**–**
Vietnam	–	–	–	–	**–**	–	–	–	–	**–**	1	1	1	1	**1**
Sub-total	85	85	87	89	**90**	13	13	11	10	**10**	27	27	24	24	**23**
Europe															
Austria	1	1	1	1	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Belgium	2	2	1	1	**1**	1	1	1	1	**1**	–	–	–	–	**–**
Denmark	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
France	7	8	9	9	**9**	3	3	3	2	**2**	–	–	–	–	**–**
Germany	7	5	4	4	**4**	–	–	–	–	**–**	–	–	–	–	**–**
Italy	4	4	4	4	**4**	–	–	–	–	**–**	–	–	–	–	**–**
Luxembourg	–	–	–	–	**–**	1	1	1	1	**–**	–	–	–	–	**–**
Netherlands	4	5	4	4	**3**	–	–	–	–	**–**	–	–	–	–	**–**
Spain	2	2	2	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Sweden	1	1	1	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Switzerland	3	3	4	5	**6**	–	–	–	–	**–**	–	–	–	–	**–**
United Kingdom	11	10	11	11	**11**	1	1	–	–	**–**	–	–	1	1	**1**
Sub-total	42	41	41	43	**44**	6	6	5	4	**3**	–	–	1	1	**1**
Middle East															
Bahrain	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
Iran	1	1	1	1	**1**	–	–	–	–	**–**	–	–	–	–	**–**
United Arab Emirates	–	2	2	2	**2**	1	1	1	1	**1**	–	–	–	–	**–**
Sub-total	1	3	3	3	**3**	1	1	1	1	**1**	–	–	–	–	**–**
North America															
Canada	5	5	5	5	**5**	1	1	1	1	**3**	–	–	–	–	**–**
United States	11	10	9	9	**9**	6	5	3	4	**4**	1	1	1	1	**–**
Sub-total	16	15	14	14	**14**	7	6	4	5	**7**	1	1	1	1	**–**
South Africa	1	1	1	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Bermuda	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
Others	–	–	–	1	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Grand Total	145	145	146	152	**155**	27	26	21	20	**21**	28	28	26	26	**24**

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

Positions at 31 December 2012	Number of Overseas Banks [b]					Licensed Banks [c]					Restricted Licence Banks [c]					Deposit-Taking Companies [c]					Local Representative Offices				
	08	09	10	11	**12**	08	09	10	11	**12**	08	09	10	11	**12**	08	09	10	11	**12**	08	09	10	11	**12**
World Ranking [a]																									
1 – 20	20	20	20	20	**20**	35	37	38	40	**39**	6	8	6	6	**6**	–	–	–	–	**–**	6	5	5	3	**2**
21 – 50	23	22	23	26	**26**	22	22	24	21	**23**	5	4	3	3	**3**	–	1	2	2	**2**	5	4	3	5	**5**
51 – 100	26	28	27	27	**24**	23	21	17	21	**22**	1	1	1	1	**1**	6	5	3	3	**3**	3	14	16	14	**3**
101 – 200	35	31	30	40	**40**	21	15	17	23	**25**	1	–	–	–	**–**	2	3	3	4	**3**	14	15	12	14	**21**
201 – 500	55	52	51	43	**48**	27	28	30	24	**25**	8	8	6	5	**5**	1	1	1	2	**3**	22	18	16	14	**17**
Sub-total	159	153	151	156	**158**	128	123	126	129	**134**	21	21	16	15	**15**	9	10	9	11	**11**	50	56	52	50	**48**
Others	46	52	48	43	**42**	17	22	20	23	**21**	6	5	5	5	**6**	19	18	17	15	**13**	21	15	15	11	**12**
Total	205	205	199	199	**200**	145	145	146	152	**155**	27	26	21	20	**21**	28	28	26	26	**24**	71	71	67	61	**60**

(a) Top 500 banks/banking groups in the world ranked by total assets. Figures are extracted from *The Banker*, July 2012 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.

Table F Balance Sheet: All Authorized Institutions and Retail Banks

All Authorized Institutions

	2008			2009			2010			2011			**2012**		
(HK$ billion)	HK$	F/CY	Total	HK$	F/CY	Total	HK$	F/CY	Total	HK$	F/CY	Total	**HK$**	**F/CY**	**Total**
Assets															
Loans to customers	2,355	931	3,286	2,401	887	3,288	2,824	1,403	4,228	3,160	1,921	5,081	**3,333**	**2,236**	**5,569**
– Inside Hong Kong [a]	2,201	509	2,710	2,227	419	2,646	2,568	695	3,262	2,809	902	3,711	**2,938**	**1,043**	**3,981**
– Outside Hong Kong [b]	154	422	575	174	468	642	257	708	965	351	1,019	1,370	**395**	**1,193**	**1,589**
Interbank lending	542	3,483	4,025	475	3,282	3,757	399	3,743	4,142	351	4,120	4,471	**390**	**3,998**	**4,389**
– Inside Hong Kong	261	287	548	231	317	548	181	473	654	205	444	649	**234**	**423**	**656**
– Outside Hong Kong	281	3,195	3,477	244	2,966	3,209	218	3,270	3,488	146	3,676	3,822	**157**	**3,576**	**3,732**
Negotiable certificates of deposit (NCDs)	39	49	88	41	62	102	80	54	133	90	104	194	**133**	**159**	**291**
Negotiable debt instruments, other than NCDs	392	1,433	1,825	816	1,541	2,357	893	1,737	2,630	862	1,865	2,727	**821**	**2,118**	**2,939**
Other assets	605	926	1,531	666	465	1,131	550	608	1,158	566	704	1,270	**774**	**896**	**1,670**
Total Assets	3,933	6,821	10,754	4,399	6,236	10,635	4,746	7,545	12,291	5,029	8,713	13,742	**5,451**	**9,408**	**14,859**
Liabilities															
Deposits from customers [c]	3,034	3,024	6,058	3,374	3,007	6,381	3,617	3,245	6,862	3,740	3,851	7,591	**4,176**	**4,121**	**8,297**
Interbank borrowing	447	2,498	2,945	473	2,409	2,882	466	3,222	3,688	547	3,479	4,026	**574**	**3,395**	**3,969**
– Inside Hong Kong	262	292	555	228	321	549	178	478	657	201	450	651	**234**	**434**	**668**
– Outside Hong Kong	185	2,205	2,390	245	2,088	2,332	288	2,744	3,032	346	3,029	3,375	**340**	**2,961**	**3,301**
Negotiable certificates of deposit	86	22	108	69	27	96	114	61	175	144	239	383	**210**	**426**	**636**
Other liabilities	779	864	1,643	762	515	1,277	845	720	1,565	910	831	1,741	**1,035**	**922**	**1,957**
Total Liabilities	4,347	6,407	10,754	4,678	5,958	10,635	5,043	7,248	12,291	5,341	8,400	13,742	**5,995**	**8,864**	**14,859**

Retail Banks

	2008			2009			2010			2011			**2012**		
(HK$ billion)	HK$	F/CY	Total	HK$	F/CY	Total	HK$	F/CY	Total	HK$	F/CY	Total	**HK$**	**F/CY**	**Total**
Assets															
Loans to customers	1,870	366	2,236	1,963	352	2,315	2,310	622	2,932	2,567	784	3,351	**2,724**	**907**	**3,632**
– Inside Hong Kong [a]	1,787	258	2,044	1,857	229	2,086	2,150	392	2,542	2,346	462	2,808	**2,482**	**520**	**3,002**
– Outside Hong Kong [b]	83	108	191	106	123	229	160	230	391	221	322	543	**242**	**388**	**630**
Interbank lending	368	1,205	1,573	263	1,162	1,425	172	1,439	1,611	172	1,639	1,811	**200**	**1,449**	**1,648**
– Inside Hong Kong	200	172	372	168	186	353	112	284	396	123	205	329	**152**	**186**	**337**
– Outside Hong Kong	168	1,034	1,201	96	976	1,072	60	1,155	1,215	49	1,433	1,482	**48**	**1,263**	**1,311**
Negotiable certificates of deposit (NCDs)	27	25	52	28	30	58	54	27	81	57	47	104	**90**	**90**	**180**
Negotiable debt instruments, other than NCDs	293	1,074	1,367	692	1,104	1,795	620	1,257	1,876	620	1,314	1,934	**617**	**1,511**	**2,128**
Other assets	457	602	1,060	477	292	769	432	396	828	438	470	908	**588**	**599**	**1,187**
Total Assets	3,014	3,273	6,288	3,424	2,940	6,364	3,588	3,740	7,328	3,855	4,253	8,108	**4,218**	**4,556**	**8,774**
Liabilities															
Deposits from customers [c]	2,695	2,036	4,731	3,012	1,992	5,004	3,276	2,280	5,556	3,368	2,692	6,059	**3,768**	**2,855**	**6,623**
Interbank borrowing	118	356	474	165	265	430	136	486	622	165	523	687	**180**	**475**	**656**
– Inside Hong Kong	52	72	124	42	83	124	41	291	332	55	246	301	**57**	**181**	**238**
– Outside Hong Kong	66	284	350	123	182	305	95	195	290	109	277	386	**123**	**294**	**417**
Negotiable certificates of deposit	40	13	53	25	11	36	41	22	63	64	99	163	**45**	**123**	**168**
Other liabilities	566	464	1,029	625	269	894	682	406	1,088	720	478	1,198	**827**	**501**	**1,328**
Total Liabilities	**3,420**	**2,868**	**6,288**	**3,827**	**2,536**	**6,364**	**4,134**	**3,194**	**7,328**	**4,316**	**3,792**	**8,108**	**4,820**	**3,954**	**8,774**

(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 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	2011	3,448	897	1,055	2,782	5,560	13,742
	2012	**4,005**	**912**	**1,242**	**2,627**	**6,073**	**14,859**
Deposits from Customers [a]	2011	2,062	166	376	1,283	3,705	7,591
	2012	**2,274**	**145**	**426**	**1,380**	**4,072**	**8,297**
Loans to Customers	2011	1,437	375	183	856	2,230	5,081
	2012	**1,687**	**395**	**214**	**876**	**2,398**	**5,569**
Loans to Customers	2011	1,045	243	158	537	1,727	3,711
Inside Hong Kong [b]	**2012**	**1,204**	**238**	**174**	**558**	**1,807**	**3,981**
Loans to Customers	2011	392	132	25	318	502	1,370
Outside Hong Kong [c]	**2012**	**483**	**157**	**40**	**318**	**591**	**1,589**

(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)	2011 HK$	2011 F/CY	2011 Total	2012 HK$	2012 F/CY	2012 Total
Assets						
Loans to customers	336	517	853	**173**	**316**	**489**
– Inside Hong Kong [a]	241	207	449	**129**	**141**	**270**
– Outside Hong Kong [b]	94	310	404	**44**	**175**	**219**
Interbank lending	(48)	377	329	**39**	**(121)**	**(82)**
– Inside Hong Kong	24	(29)	(6)	**29**	**(21)**	**8**
– Outside Hong Kong	(71)	406	334	**10**	**(100)**	**(90)**
All other assets	(4)	274	269	**209**	**501**	**710**
Total Assets	284	1,167	1,451	**422**	**695**	**1,117**
Liabilities						
Deposits from customers [c]	123	606	729	**436**	**270**	**706**
Interbank borrowing	81	257	338	**27**	**(84)**	**(57)**
– Inside Hong Kong	23	(28)	(6)	**33**	**(16)**	**17**
– Outside Hong Kong	59	285	344	**(6)**	**(68)**	**(75)**
All other liabilities	94	290	384	**191**	**277**	**468**
Total Liabilities	299	1,152	1,451	**654**	**463**	**1,117**
Net Interbank Borrowing/(Lending)	129	(120)	10	**(13)**	**37**	**24**
Net Customer Lending/(Borrowing)	213	(89)	124	**(263)**	**45**	**(217)**

Retail Banks

Increase/(Decrease) in (HK$ billion)	2011 HK$	2011 F/CY	2011 Total	2012 HK$	2012 F/CY	2012 Total
Assets						
Loans to customers	257	162	419	**157**	**124**	**281**
– Inside Hong Kong [a]	196	71	267	**136**	**58**	**193**
– Outside Hong Kong [b]	61	91	152	**21**	**66**	**87**
Interbank lending	0	200	200	**27**	**(190)**	**(163)**
– Inside Hong Kong	11	(79)	(68)	**28**	**(19)**	**9**
– Outside Hong Kong	(11)	278	267	**(1)**	**(171)**	**(172)**
All other assets	9	151	161	**180**	**369**	**549**
Total Assets	266	513	779	**364**	**303**	**667**
Liabilities						
Deposits from customers [c]	92	412	504	**400**	**163**	**563**
Interbank borrowing	29	37	66	**16**	**(48)**	**(32)**
– Inside Hong Kong	14	(45)	(31)	**2**	**(65)**	**(63)**
– Outside Hong Kong	15	82	96	**14**	**18**	**31**
All other liabilities	60	150	210	**89**	**47**	**135**
Total Liabilities	181	598	779	**505**	**162**	**667**
Net Interbank Borrowing/(Lending)	29	(163)	(134)	**(11)**	**142**	**131**
Net Customer Lending/(Borrowing)	165	(250)	(85)	**(243)**	**(40)**	**(283)**

(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 HK$	Loans to Customers F/CY	Loans to Customers Total	Loans to Customers %	Deposits from Customers [a] HK$	Deposits from Customers [a] F/CY	Deposits from Customers [a] Total	Deposits from Customers [a] %
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	5,020	99	3,731	3,837	7,568	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
2012								
Licensed banks	**3,290**	**2,216**	**5,506**	**99**	**4,168**	**4,109**	**8,277**	**100**
Restricted licence banks	**20**	**16**	**35**	**1**	**3**	**10**	**13**	**–**
Deposit-taking companies	**23**	**5**	**27**	**–**	**5**	**2**	**7**	**–**
Total	**3,333**	**2,236**	**5,569**	**100**	**4,176**	**4,121**	**8,297**	**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	2008		2009		2010		2011		**2012**	
(HK$ billion)	HK$	%	HK$	%	HK$	%	HK$	%	**HK$**	**%**
Hong Kong's visible trade	186	7	175	7	274	8	350	9	**383**	**10**
Manufacturing	147	5	127	5	162	5	190	5	**181**	**5**
Transport and transport equipment	155	6	151	6	168	5	193	5	**217**	**5**
Building, construction and property development, and investment	687	25	687	26	827	25	918	25	**930**	**23**
Wholesale and retail trade	152	6	150	6	229	7	314	8	**353**	**9**
Financial concerns (other than authorized institutions)	283	10	186	7	235	7	264	7	**277**	**7**
Individuals										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	57	2	52	2	51	2	46	1	**42**	**1**
– to purchase other residential property	593	22	647	24	745	23	805	22	**873**	**22**
– other purposes	226	8	222	8	256	8	292	8	**334**	**8**
Others	223	8	250	9	315	10	340	9	**392**	**10**
Total [a]	2,710	100	2,646	100	3,262	100	3,711	100	**3,981**	**100**

Retail Banks

Sector	2008		2009		2010		2011		**2012**	
(HK$ billion)	HK$	%	HK$	%	HK$	%	HK$	%	**HK$**	**%**
Hong Kong's visible trade	147	7	131	6	208	8	242	9	**257**	**9**
Manufacturing	97	5	87	4	114	4	129	5	**121**	**4**
Transport and transport equipment	92	4	95	5	102	4	115	4	**130**	**4**
Building, construction and property development, and investment	536	26	556	27	663	26	719	26	**735**	**24**
Wholesale and retail trade	99	5	102	5	161	6	207	7	**222**	**7**
Financial concerns (other than authorized institutions)	106	5	84	4	106	4	113	4	**123**	**4**
Individuals										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	57	3	52	2	51	2	46	2	**42**	**1**
– to purchase other residential property	579	28	634	30	734	29	794	28	**860**	**29**
– other purposes	188	9	186	9	209	8	245	9	**274**	**9**
Others	144	7	159	8	193	8	199	7	**238**	**8**
Total [a]	2,044	100	2,086	100	2,542	100	2,808	100	**3,002**	**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]								
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	3,368
2012	**639**	**2,007**	**1,530**	**4,176**	**577**	**1,982**	**1,209**	**3,768**
Foreign Currency								
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
2012	**456**	**1,378**	**2,287**	**4,121**	**293**	**1,191**	**1,371**	**2,855**
Total								
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
2012	**1,095**	**3,385**	**3,817**	**8,297**	**869**	**3,173**	**2,580**	**6,623**

(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)	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)	2012 Net Claims on/ (Liabilities to) Banks Outside Hong Kong	2012 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	2012 Total Net Claims/ (Liabilities)
Asia & Pacific	1,521	(112)	1,409	1,802	(137)	1,664
Mainland China	1,172	(89)	1,083	1,103	(79)	1,024
Australia	256	52	307	236	27	264
South Korea	200	49	250	199	44	243
India	61	102	164	80	119	199
Singapore	106	(105)	1	251	(101)	149
Thailand	5	(21)	(16)	44	(24)	20
Malaysia	21	(13)	8	42	(24)	17
Philippines	(2)	(8)	(9)	18	(2)	16
Bangladesh	4	0	4	8	0	7
Vietnam	5	0	6	6	1	7
Sri Lanka	3	2	6	4	2	5
Cambodia	0	0	0	2	2	4
Indonesia	7	1	8	9	(7)	2
Maldives	1	0	1	0	0	1
Republic of Kazakhstan	0	1	2	0	1	1
New Zealand	5	0	5	2	(2)	0
Papua New Guinea	0	(2)	(2)	0	0	0
Pakistan	0	0	0	0	0	(1)
Vanuatu	0	(1)	(1)	0	(1)	(1)
Myanmar	(1)	0	(1)	(1)	0	(1)
Nepal	(2)	0	(2)	(6)	0	(6)
Brunei	(12)	(3)	(15)	(7)	(2)	(9)
Western Samoa	0	(15)	(15)	0	(15)	(15)
Japan	(315)	146	(168)	(228)	179	(50)
Taiwan	112	(198)	(86)	141	(235)	(95)
Macau SAR	(103)	(9)	(112)	(95)	(19)	(115)
Others	(4)	(4)	(8)	(4)	1	(3)
North America	(129)	160	32	(240)	186	(54)
Canada	(2)	7	5	20	19	39
United States	(126)	153	27	(261)	167	(93)
Caribbean	54	(66)	(12)	46	(46)	0
Bahamas	52	(7)	45	56	(3)	53
Cayman Islands	2	18	21	(10)	14	4
Panama	0	5	5	0	3	3
Barbados	0	1	1	0	0	0
Bermuda	0	(4)	(4)	0	(3)	(3)
Others	0	(80)	(80)	0	(58)	(58)
Africa	(1)	(3)	(4)	(1)	(25)	(27)
Mauritius	0	2	1	0	1	1
Kenya	0	0	0	0	1	1
Liberia	0	0	0	0	(1)	(1)
South Africa	2	0	2	2	(4)	(2)
Nigeria	(1)	0	(1)	(4)	0	(4)
Others	(1)	(6)	(7)	0	(21)	(22)

Table L Geographical Breakdown of Net External Claims/ (Liabilities) of All Authorized Institutions (continued)

Region/Economy (HK$ billion)	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)	**2012 Net Claims on/ (Liabilities to) Banks Outside Hong Kong**	**2012 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong**	**2012 Total Net Claims/ (Liabilities)**
Latin America	6	3	9	**4**	**(1)**	**3**
Mexico	1	4	5	**1**	**3**	**4**
Brazil	5	0	5	**2**	**0**	**2**
Peru	0	2	2	**0**	**2**	**2**
Venezuela	0	(1)	(1)	**3**	**(1)**	**2**
Chile	0	1	1	**0**	**0**	**1**
Others	0	(3)	(3)	**(2)**	**(5)**	**(7)**
Eastern Europe	4	(2)	3	**1**	**(2)**	**(1)**
Western Europe	150	101	251	**248**	**98**	**346**
France	28	41	68	**91**	**40**	**131**
Germany	29	38	67	**79**	**38**	**117**
United Kingdom	122	(3)	119	**70**	**10**	**80**
Switzerland	50	(6)	44	**50**	**(6)**	**44**
Luxembourg	16	1	17	**16**	**(1)**	**16**
Sweden	8	4	12	**6**	**4**	**10**
Belgium	(19)	1	(18)	**8**	**0**	**8**
Turkey	5	0	5	**6**	**0**	**6**
Denmark	3	0	3	**6**	**0**	**6**
Jersey	7	1	8	**5**	**0**	**4**
Austria	(1)	0	(1)	**3**	**0**	**4**
Republic of Ireland	0	4	4	**0**	**4**	**4**
Norway	4	2	6	**5**	**(2)**	**3**
Cyprus	0	0	0	**0**	**1**	**1**
Iceland	1	0	1	**1**	**0**	**1**
Finland	2	0	1	**1**	**0**	**1**
Guernsey	0	(1)	(1)	**1**	**(1)**	**0**
Liechtenstein	(1)	0	(1)	**0**	**(1)**	**0**
Portugal	0	0	0	**0**	**0**	**(1)**
Gibraltar	0	(1)	(1)	**0**	**(1)**	**(1)**
Malta	(6)	0	(6)	**(3)**	**1**	**(3)**
Spain	(48)	6	(41)	**(22)**	**0**	**(23)**
Netherlands	(8)	15	7	**(41)**	**16**	**(24)**
Italy	(43)	3	(40)	**(34)**	**(2)**	**(37)**
Others	0	0	0	**0**	**0**	**0**
Middle East	(21)	60	39	**(29)**	**55**	**26**
United Arab Emirates	(5)	31	26	**1**	**29**	**30**
Qatar	1	19	20	**1**	**17**	**19**
Bahrain	0	0	0	**9**	**0**	**10**
Egypt	(1)	1	1	**(1)**	**1**	**1**
Israel	0	(1)	(1)	**0**	**(1)**	**(1)**
Oman	(3)	0	(3)	**(3)**	**0**	**(2)**
Kuwait	(12)	(1)	(12)	**(11)**	**(2)**	**(13)**
Saudi Arabia	1	9	10	**(27)**	**10**	**(17)**
Others	(1)	0	(1)	**0**	**0**	**0**
Others [a]	68	4	71	**56**	**2**	**58**
Overall Total	1,653	145	1,797	**1,886**	**129**	**2,016**

(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
AMLO	–	Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance
ASEAN	–	Association of Southeast Asian Nations
BAO 2012	–	Banking (Amendment) Ordinance 2012
BCAR 2012	–	Banking (Capital) (Amendment) Rule 2012
CEPA	–	Closer Economic Partnership Arrangement
CFT	–	Counter-terrorist-financing
CHATS	–	Clearing House Automated Transfer System
CMIM	–	Chiang Mai Initiative Multilateralisation
CMU	–	Central Moneymarkets Unit
CPSS	–	Committee on Payment and Settlement Systems
CSDs	–	Central Securities Depositories
CSSO	–	Clearing and Settlement Systems Ordinance
CU	–	Convertibility Undertaking
DPS	–	Deposit Protection Scheme
D-SIBs	–	Domestic systemically important banks
DvP	–	Delivery-versus-Payment
e-bill	–	Electronic bill presentment and 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
FMIs	–	Financial market infrastructures
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
HKAB	–	Hong Kong Association of Banks
HKDPB	–	Hong Kong Deposit Protection Board
HKFRSs	–	Hong Kong Financial Reporting Standards
HKIB	–	Hong Kong Institute of Bankers
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
HKSI	–	Hong Kong Securities and Investment Institute
HQLA	–	High-quality liquid assets
IEC	–	Investor Education Centre
ILAS	–	Investment-linked assurance scheme
IMF	–	International Monetary Fund
IMM approach	–	Internal models approach
IOSCO	–	International Organization of Securities Commissions
IRB approach	–	Internal ratings-based approach
ISC	–	Investment Sub-Committee
LCR	–	Liquidity coverage ratio
LegCo	–	Legislative Council
LERS	–	Linked Exchange Rate system
LTGP	–	Long-Term Growth Portfolio
MPF	–	Mandatory Provident Fund
NFC	–	Near field communication
OCI	–	Office of the Commissioner of Insurance
OCL	–	Octopus Cards Limited
OECD	–	Organisation for Economic Co-operation and Development
OTC	–	Over-the-counter
PBoC	–	People's Bank of China
PvP	–	Payment-versus-Payment
RMB	–	Renminbi
RMC Division	–	Risk Management and Compliance Division
RQFII	–	Renminbi Qualified Foreign Institutional Investor
RTGS	–	Real Time Gross Settlement
SFC	–	Securities and Futures Commission
SFO	–	Securities and Futures Ordinance
SRP	–	Supervisory review process
TMA	–	Treasury Markets Association
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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Money in Hong Kong

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Educational leaflets on various topics including notes and coins and banking issues

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