HONG KONG MONETARY AUTHORITY
香港金融管理局

2013
Annual Report

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,
8 Finance Street,
Central,
Hong Kong
Telephone : (852) 2878 8196
Facsimile : (852) 2878 8197
E-mail : hkma@hkma.gov.hk

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 2013 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 2013

Economic and Financial Environment

The Hong Kong economy grows faster with the support of stronger domestic demand and improving export performance. The Hang Seng Index records modest gains in a volatile market, while the residential property market is under consolidation.

Despite accelerating credit growth, retail banks' asset quality and liquidity positions remain sound. Profitability of retail banks grows and their net interest margin widens. Locally incorporated authorized institutions continue to be well capitalised.

Monetary Stability

Hong Kong dollar exchange rate against US dollar remains stable within the Convertibility Zone. The Government reiterates its full commitment to the Linked Exchange Rate system with strong public confidence in the Hong Kong dollar.

Money market activities are orderly with abundant interbank liquidity, and Hong Kong dollar interest rates edge modestly higher.

Banking Stability

The HKMA maintains its supervisory focus on banks' credit and liquidity risk management amid fiscal and economic uncertainties in the US and Europe.

The sixth round of macroprudential measures on mortgage loans and a Stable Funding Requirement are introduced to enhance the resilience of the banking sector. Supervision of banks' Mainland-related business and their compliance with anti-money laundering requirements is also strengthened.

The year sees the implementation of the first phase of the Basel III standards, the establishment of the Private Wealth Management Association and the launch of consumer protection initiatives, such as the consumer education programme and the Treat Customers Fairly Charter.

International Financial Centre

Hong Kong's position as the premier offshore renminbi business centre gains further momentum with remarkable growth in a full range of renminbi business activities. The first offshore renminbi interbank interest rate fixing has been launched. International co-operation platforms with Australia, London, and Malaysia help promote the breadth and depth of the offshore renminbi market.

The HKMA also actively participates in international and regional forums as well as co-operative initiatives to promote financial stability and to enhance Asia's collective voice on global economic and financial affairs. The reporting function of the local trade repository for over-the-counter derivatives is launched and there is further headway in developing Islamic finance in Hong Kong.

Reserves Management

Despite a volatile global investment environment, the Exchange Fund records an investment income of $81.2 billion, a return of 2.7%.

Total assets of the Exchange Fund reach $3,032.8 billion at the end of 2013.

The HKMA continues to diversify part of the Fund's investment into various asset classes. At the end of 2013, the market value of investments under the Long-Term Growth Portfolio (LTGP) totals $88.6 billion, with outstanding investment commitments amounting to $80.2 billion.

Corporate Functions

The HKMA continues to strengthen its connection with the community through timely dissemination of information on its website, effective communication with the media, and other public education activities.

Critical internal reviews are carried out and concrete measures are taken to ensure efficient deployment of resources. HKMA staff maintain professionalism in upholding best practices in financial budgeting and disclosure, internal controls, risk management, general support and governance. Staff members also actively participate in green initiatives and charity work.

Chief Executive's Statement

2013 was a special year for the HKMA: it marked the 30th anniversary of the Linked Exchange Rate system (LERS) and the 20th anniversary of the establishment of the HKMA. These two important milestones are timely reminders of our heavy responsibility in safeguarding the stability of Hong Kong's monetary and financial systems and promoting Hong Kong as an international financial centre.

It was also an eventful year for financial markets around the globe. Although overall market sentiment improved somewhat, market volatilities were unavoidable in the face of lingering uncertainties over economic recovery in the US and other advanced economies, possible exit from quantitative easing by the US Federal Reserve, as well as the timing, magnitude and speed of the exit. In May and June last year, the Fed Chairman's remarks about a possible timeline for tapering triggered a significant sell-off in global equity and bond markets and in emerging market economies. In December 2013, the Fed announced its decision to start tapering from January 2014. The market initially reacted calmly, with the S&P 500 and the Dow Jones indices both closing at record highs on the day of the announcement. At the same time, there were signs of a continued outflow of funds from the emerging markets.

In such a highly uncertain external environment, the HKMA closely monitored market movements and took timely measures to better prepare our banking and financial systems to weather possible shocks. After touching the strong-side Convertibility Undertaking in late 2012 due to a large influx of funds into the Hong Kong dollar, the Hong Kong dollar softened slightly against the US dollar in the first half of 2013. In the second half of the year, the exchange rate turned slightly stronger due to mild inflows. In spite of unpredictable international capital flows and widespread currency fluctuations among emerging market economies, the Hong Kong dollar remained stable throughout the year, again highlighting the fact that the LERS has been an effective cornerstone of Hong Kong's monetary and financial stability since October 1983. When announcing the results of its annual Article IV Consultation for Hong Kong in January 2013, the International Monetary Fund reaffirmed that the LERS remained the best arrangement for Hong Kong. The Government also emphasised its firm commitment to maintaining the LERS.

In order to strengthen our banking system's capacity against the potential impact of US interest rate normalisation on Hong Kong's property and mortgage markets, the HKMA launched its sixth round of countercyclical prudential measures in February 2013. These included raising the interest rate hike assumption for property mortgage loans' approval to 300 basis points and lowering the maximum applicable loan-to-value ratio for non-residential mortgages. As a result of these prudential measures and the Government's demand management tax measures, Hong Kong's property transaction volume dropped significantly in 2013. Property price increases moderated, and the growth in residential mortgage loans slowed from 7.6% in 2012 to 3.9% in 2013. Meanwhile, the aggregate credit growth in the banking sector accelerated from 9.6% in 2012 to 16%. To reduce the risks arising from this rapid credit expansion, the HKMA launched the Stable Funding Requirement in October 2013, requiring banks to ensure stable funding to support the rapid growth of their lending. Credit growth slowed slightly in the fourth quarter of 2013, but picked up sharply again in January 2014. In view of this, in February 2014 the HKMA decided to bring forward the review of banks' credit growth to the end of March to assess their compliance with the Stable Funding Requirement.

In 2013, the HKMA implemented the first phase of Basel III capital standards and related disclosure requirements, in compliance with the new international standards of banking regulatory reforms. To tackle the "too-big-to-fail" problem, we also pushed ahead with the preparatory work for the establishment of an effective resolution regime for financial institutions in Hong Kong, with the launch in early 2014 of the first round of public consultation on the proposed regime. The HKMA also supported and collaborated with stakeholders in setting up the Private Wealth Management Association, which seeks to promote and develop good conduct, integrity and professional competence among practitioners and boost the private wealth management business in Hong Kong. To assist in the protection of financial consumers, the HKMA launched the consumer education programme to promote smart and responsible use of banking products and services. We also engaged the banking sector to develop the Treat Customers Fairly Charter, which was supported and signed up to by 22 Hong Kong retail banks in October. We will continue to work with the signatory banks to implement the principles enshrined in the Charter so that the spirit of fair treatment of customers becomes an integral part of their businesses. In 2013, the HKMA also significantly strengthened its manpower to supervise banks' anti-money laundering work and to enhance bank management's risk awareness and governance culture in this area.

The HKMA's efforts in strengthening Hong Kong's position as an offshore renminbi business centre achieved encouraging results. Both the size and liquidity of our offshore renminbi pool improved significantly in 2013. The amount of renminbi trade settlement handled by banks in Hong Kong increased to RMB3,841 billion, a 46% increase over 2012; total outstanding renminbi customer deposits and certificates of deposit surpassed the important threshold of RMB1 trillion for the first time; and outstanding renminbi bank loans grew to RMB115.6 billion, a 46% jump from 2012, amid sustained growth in renminbi bank loan business. With the increasing use of renminbi in cross-border trade and offshore financial activities, the average daily turnover of Hong Kong's renminbi Real Time Gross Settlement system (RTGS) exceeded RMB500 billion in December 2013, almost double the RMB264.4 billion over the same period in 2012. The HKMA also worked closely with relevant Mainland authorities to pursue a number of policies and improvements to cross-border renminbi businesses, including the broadening of two-way renminbi investment channels, such as expanding the scope of eligible institutions and relaxing the investment restrictions under the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme and allowing cross-border investment using renminbi funds under the Qualified Domestic Institutional Investor (QDII) scheme, as well as streamlining the requirements for cross-border renminbi businesses. We will continue to closely communicate with relevant authorities in the Central People's Government to introduce more policies and initiatives conducive to the sustainable development of Hong Kong's offshore renminbi business.

With this in mind, the HKMA continues to enhance the renminbi payment and settlement platform. Since January 2013, and with the support of the People's Bank of China Shenzhen Central Sub-Branch, the clearing houses in Hong Kong and Shenzhen have started a pilot arrangement that links Hong Kong's renminbi RTGS system with the Shenzhen Financial Settlement System. The arrangement extends the operating hours of the cross-border renminbi payment services between Hong Kong and the Mainland from 4:30 p.m. to 10:30 p.m., enabling Hong Kong's renminbi clearing platform to more fully support Mainland and overseas renminbi payments. This is an important initiative to further enhance the operational capabilities of Hong Kong as an offshore renminbi centre. In addition, the HKMA improved the liquidity of Hong Kong's renminbi capital market through enhancements to the renminbi liquidity facility arrangement, which included shortening the required notice period for obtaining one-week renminbi funds under this arrangement from two business days to one, and introducing the provision of one-day funds on a next-day (T+1) basis as well as overnight funds of up to RMB10 billion on a same-day (T+0) basis. The HKMA also sought to strengthen overseas linkages and promote more renminbi business dealings between banks in Hong Kong and the rest of the world to create win-win opportunities. During the year, financial institutions in Hong Kong held their first meetings with counterparts in Australia and Malaysia on co-operation in renminbi business, and the third meeting of the Hong Kong-London Renminbi Forum was held in September.

The development of Islamic finance in Hong Kong, a Government initiative supported by the HKMA, advanced to another stage with the Legislative Council passing in July the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012. The legislation establishes a comparable taxation framework for Islamic bonds vis-à-vis conventional bonds, and we are proactively preparing for the issuance of Islamic bonds under the Government Bond Programme to foster Hong Kong's bond market development. To promote market's awareness, understanding and participation in Islamic finance, we worked closely with overseas central banks, international organisations and local stakeholders in organising a number of Islamic finance seminars and workshops to provide training for market participants. These seminars and workshops were well received. In 2013, we also joined hands with Bank Negara Malaysia to establish a private-sector led Joint Forum that seeks to strengthen co-operation between Hong Kong and Malaysia in the field of Islamic finance. The Forum held its first meeting in December.

In spite of the difficult investment environment in global financial markets in 2013, the Exchange Fund recorded an investment income of HK$81.2 billion. The bond market was exceptionally volatile throughout the year. US bond market reacted strongly in May and June following the Fed's tapering talks, with 10-year US Treasury bond yields once surging more than 100 basis points, leading to a sharp fall in bond prices. The Exchange Fund's Backing Portfolio, which holds top quality and liquid US dollar assets to back the Monetary Base, was inevitably affected by the rising bond yields. These developments resulted in a HK$4.2 billion loss in the Exchange Fund in the first half of 2013. In the second half, the improved market sentiment and the good performance of stock markets in the fourth quarter brought the Exchange Fund an investment income of HK$85.4 billion, recovering its lost ground. Indeed, in the past few years, we have taken defensive measures in the allocation of the Exchange Fund's assets to mitigate the risk to our bond portfolios that may arise from rising interest rates. These measures included increasing the proportion of cash, cash equivalents and bonds denominated in other foreign currencies in the Investment Portfolio. To better manage risk and generate higher medium- to long-term returns, we have, since 2008, been diversifying the Exchange Fund's investments in a prudent and gradual manner into alternative asset classes, such as emerging market bonds and equities, private equity, overseas properties, as well as renminbi bonds and equities. And, we are making good progress. At the end of 2013, the aggregate market value of private equity and real estate investments totalled HK$88.6 billion, recording an annualised internal rate of return of around 15.9% since inception. The outstanding undrawn investment commitments totalled HK$80.2 billion, while the aggregate investments were capped at one-third of the Accumulated Surplus of the Exchange Fund, that is, around HK$212 billion.

Looking ahead, the global financial environment and investor sentiment will be primarily driven by the pace and scale of the Fed's exit from quantitative easing and the corresponding reactions of global interest rates. However, there is still some uncertainty in the speed and sustainability of the US and European recovery. Indeed, the European economy, which is still suffering from high unemployment rates and high levels of public and private debt, is unlikely to see any significant pick-up in the immediate future. In anticipation of the US gradually exiting from quantitative easing and the normalisation of interest rates, we expect that emerging markets and Hong Kong will not be immune from the effects of a continued outflow of funds. In the face of the expected unstable financial and investment environment in 2014, the HKMA will continue to closely monitor market developments to help safeguard monetary stability, and require banks to step up the management of interest rate, liquidity and credit risks. We will also continue to prudently manage the Exchange Fund.

Since its establishment in 1993, the HKMA has all along strived to safeguard Hong Kong's monetary and financial stability, which is the prerequisite for Hong Kong's success in tackling future challenges in an uncertain and unstable global economic and financial environment.

Norman T.L. CHAN
Chief Executive

About the HKMA

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

THE HKMA'S LEGAL MANDATE

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

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

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

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

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

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

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

THE HKMA AND THE HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT

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

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

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

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

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

About the HKMA

ACCOUNTABILITY AND TRANSPARENCY

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

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

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

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

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

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

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

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

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

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

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

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 2013 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 seven times in 2013 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 three times in 2013 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 2013 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 2013.

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 2013 the Sub-Committee met three times.

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

Banking Advisory Committee

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

Deposit-Taking Companies Advisory Committee

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

Chief Executive's Committee

The Chief Executive's Committee comprises the Chief Executive of the HKMA, who chairs the Committee, the Deputy Chief Executives and the Executive Directors of the HKMA. The Committee meets regularly 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

1 January 2014

Chairman

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

Members

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

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
Regional Chief Executive Officer, Greater China
Executive Director and Chief Executive Officer, Hong Kong
Standard Chartered Bank (Hong Kong) Limited

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

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

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

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

Mr Carlson TONG, JP
Chairman
Securities and Futures Commission

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

Dr LO Ka-shui, GBS, JP
Chairman and Managing Director
Great Eagle Holdings Limited

Advisory Committees

Professor Stephen CHEUNG Yan-leung, BBS, JP
President
The Hong Kong Institute of Education

Mrs Angelina LEE WONG Pui-ling, SBS, JP
Partner
Woo, Kwan, Lee & Lo

Mr Philip TSAI Wing-chung, JP
Audit Partner
Deloitte Touche Tohmatsu

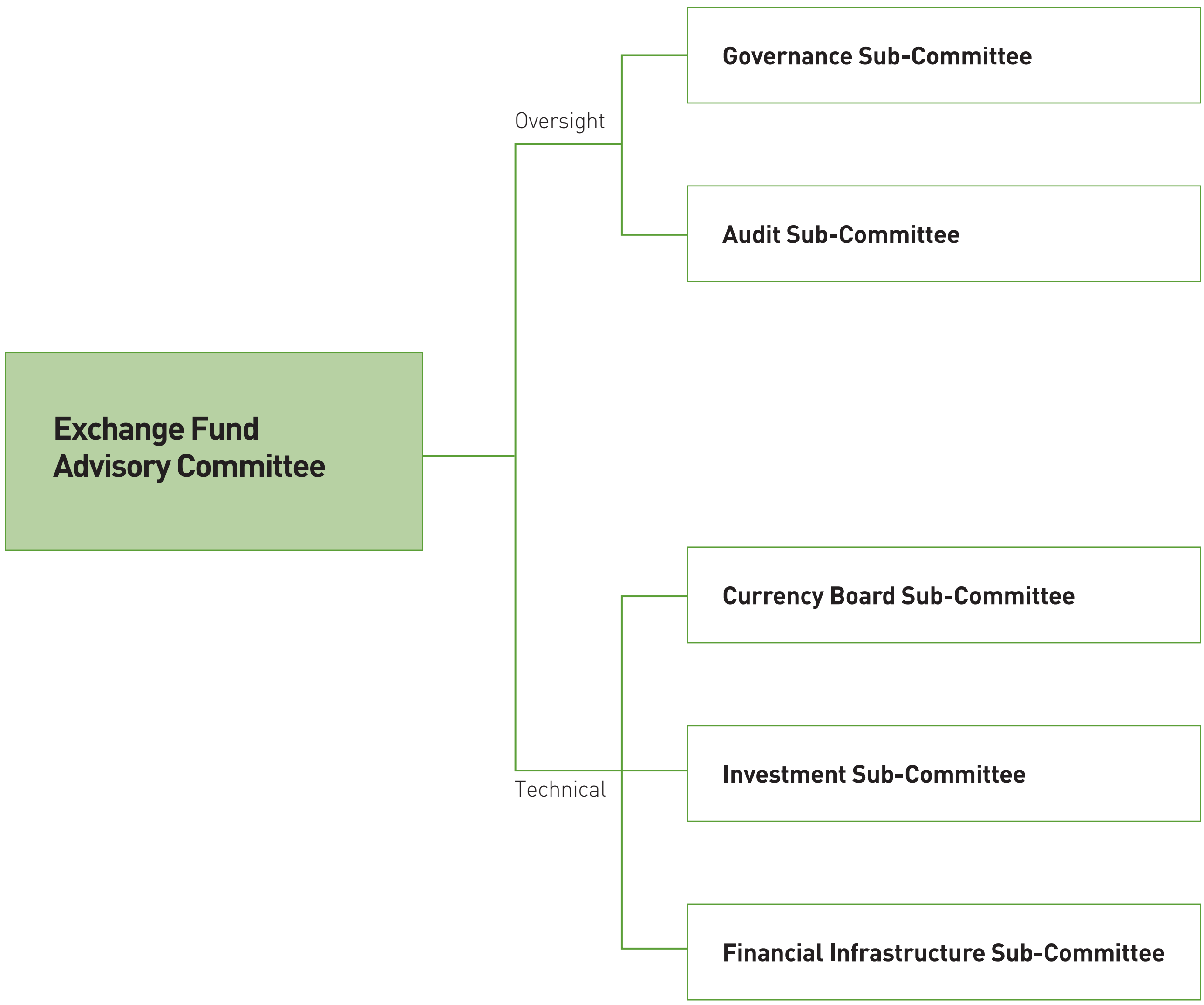
Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited
(until 9 December 2013)

Secretary

Mr Clement LAU
(from 5 February 2013)

Mr Alan AU
(until 4 February 2013)

THE EXCHANGE FUND ADVISORY COMMITTEE SUB-COMMITTEE STRUCTURE



Advisory Committees

THE EXCHANGE FUND ADVISORY COMMITTEE GOVERNANCE SUB-COMMITTEE

Chairman

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
(from 15 April 2013)

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited
(until 14 April 2013)

Members

Dr John CHAN Cho-chak, GBS, JP

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

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

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

Mr Carlson TONG, JP
Chairman
Securities and Futures Commission

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

Dr LO Ka-shui, GBS, JP
Chairman and Managing Director
Great Eagle Holdings Limited

Professor Stephen CHEUNG Yan-leung, BBS, JP
President
The Hong Kong Institute of Education

Mr Philip TSAI Wing-chung, JP
Audit Partner
Deloitte Touche Tohmatsu

Mrs Angelina LEE WONG Pui-ling, SBS, JP
Partner
Woo, Kwan, Lee & Lo

Secretary

Mr Clement LAU
(from 5 February 2013)

Mr Alan AU
(until 4 February 2013)

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

Members

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

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

Mrs Angelina LEE WONG Pui-ling, SBS, JP
Partner
Woo, Kwan, Lee & Lo
(from 19 June 2013)

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

Mr Philip TSAI Wing-chung, JP
Audit Partner
Deloitte Touche Tohmatsu

Secretary

Mr Clement LAU
(from 5 February 2013)

Mr Alan AU
(until 4 February 2013)

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

Mr HE Guangbei, JP
Chairman
The Hong Kong Association of Banks
(from 1 January 2014)

Mr Benjamin HUNG Pi-cheng, JP
Chairman
The Hong Kong Association of Banks
(until 31 December 2013)

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

Dr PENG Wensheng
Managing Director
Chief Economist
China International Capital Corporation
(from 1 January 2014)

Secretary

Mr Clement LAU
(from 5 February 2013)

Mr Alan AU
(until 4 February 2013)

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

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

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

Mr Peter WONG Tung-shun, JP
Deputy Chairman and Chief Executive
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

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited
(until 9 December 2013)

Secretary

Mr Clement LAU
(from 5 February 2013)

Mr Alan AU
(until 4 February 2013)

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

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

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

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

Professor Stephen CHEUNG Yan-leung, BBS, JP
President
The Hong Kong Institute of Education

Mrs Ayesha MACPHERSON LAU, JP
Partner in Charge, Tax – Hong Kong SAR
KMPG
(from 1 January 2014)

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

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

Mr Jack CHEUNG Tai-keung
Chief Executive Officer
Treasury Markets Association
(from 1 December 2013)

Dr Christopher CHENG Wai-chee, GBS, JP
Chairman
Wing Tai Properties Limited
(until 9 December 2013)

Secretary

Mr Clement LAU
(from 5 February 2013)

Mr Alan AU
(until 4 February 2013)

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
Regional Chief Executive Officer, Greater China
Executive Director and Chief Executive Officer, Hong Kong
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

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

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, BBS
Group General Manager
Chief Executive Officer Hong Kong
The Hongkong and Shanghai Banking Corporation Limited
Representing The Hongkong and Shanghai Banking Corporation Limited

The Honourable NG Leung-sing, SBS, JP
Member
Legislative Council

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

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

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
President & Executive Director
China Construction Bank (Asia) Corporation Limited

Ms Joan HO Yuk-wai
Partner
Financial Services
KPMG

Secretary

Ms Jasmin FUNG

Chief Executive's Committee

1 January 2014

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

Francis CHU, JP
Executive Director (Reserves Management)

Esmond LEE, JP
Executive Director (Financial Infrastructure)

Karen KEMP, JP
Executive Director (Banking Policy)

Dong HE, JP
Executive Director (Research)

Meena DATWANI, JP
Executive Director (Banking Conduct)

Carmen CHU, JP
Executive Director (External)

Howard LEE, JP
Executive Director (Monetary Management)
(from 1 May 2013)

Executive Director (Corporate Services)
(until 14 April 2013)

Vincent LEE, JP
Director-General (Enforcement)

Chief Executive's Committee

Henry CHENG
Executive Director (Banking Supervision)
(from 1 April 2013)

Darryl CHAN
Executive Director (Corporate Services)
(from 15 April 2013)

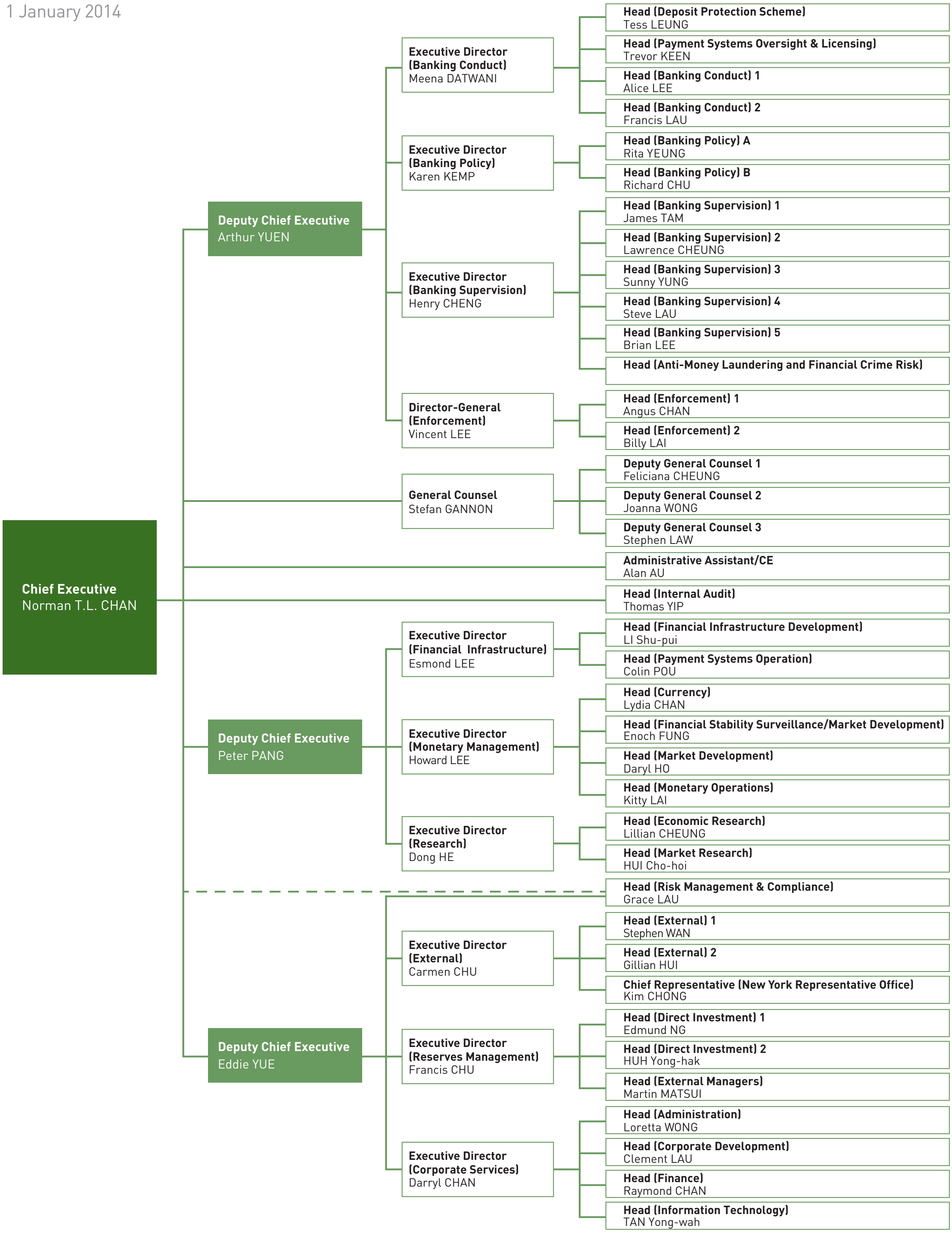
Raymond LI, JP
Chief Executive Officer
Hong Kong Mortgage Corporation

Edmond LAU, JP
Executive Director (Monetary Management)
(until 30 April 2013)

Nelson MAN, JP
Executive Director (Banking Supervision)
(until 31 March 2013)

HKMA Organisation Chart

1 January 2014



Economic and Financial Environment

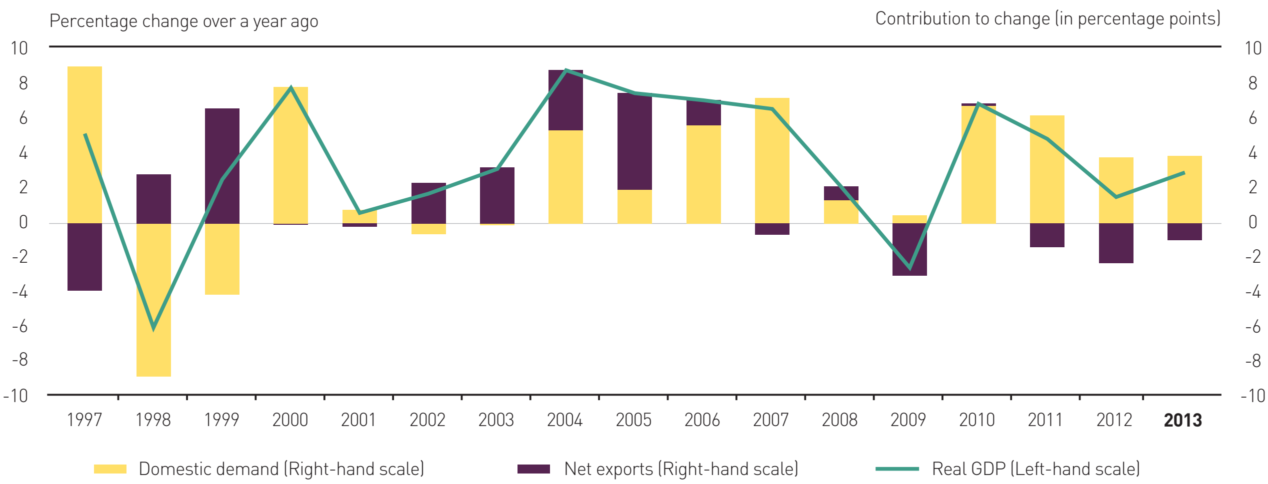
The Hong Kong economy grew moderately on the back of solid domestic demand and a mild recovery in external demand. Economic growth is expected to improve in 2014, although the uncertainty stemming from the normalisation of the US monetary policy continues to pose a major risk.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy grew at a moderate pace in 2013, with domestic demand providing the main support and export performance improving gradually (Chart 1). In particular, a pick-up in the sequential momentum later in the year helped raise the full-year real GDP growth rate to 2.9% from a modest 1.5% in 2012 (Table 1). The labour market was still relatively tight, with the unemployment rate remaining at a low level. Consumer price pressure remained, albeit moderating slightly towards the end of the year amid milder increases in housing rentals. The equity market fluctuated on concerns about the reduction of the US Federal Reserve's asset purchases and the uncertain growth prospects in Mainland China and other emerging market economies. Following the introduction of a new round of property market measures in Hong Kong in early 2013, the property market turned less exuberant, characterised by a moderation in housing price inflation and reduced transactions.

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)	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2013	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2012
Gross Domestic Product	**0.5**	**0.6**	**0.7**	**1.1**	**2.9**	0.2	0.3	0.9	1.1	1.5
(year-on-year growth)	**2.9**	**3.1**	**2.8**	**3.0**		0.7	0.9	1.6	2.9	
Private consumption expenditure	**3.1**	**-1.1**	**-0.4**	**1.7**	**4.2**	1.1	0.4	1.4	1.1	4.1
Government consumption expenditure	**0.3**	**1.5**	**0.2**	**1.1**	**2.7**	1.3	0.7	0.8	0.3	3.6
Gross domestic fixed capital formation	**–**	**–**	**–**	**–**	**3.3**	–	–	–	–	6.8
Exports										
Exports of goods	**1.5**	**-1.4**	**3.2**	**2.1**	**6.7**	0.8	-0.3	3.2	3.3	1.8
Exports of services	**2.1**	**3.2**	**-2.6**	**2.3**	**5.8**	0.6	0.6	-0.7	2.9	2.2
Imports										
Imports of goods	**3.5**	**-1.8**	**1.9**	**2.5**	**7.6**	3.0	-0.8	2.3	3.7	3.0
Imports of services	**1.5**	**-1.7**	**1.7**	**2.3**	**1.5**	1.9	-0.7	-1.9	1.4	1.9
Overall trade balance (% of GDP)	**-1.9**	**-5.7**	**6.7**	**4.0**	**1.1**	0.4	-5.2	5.4	3.1	1.1

Note: The seasonally-adjusted quarter-on-quarter rates of change in the gross domestic fixed capital formation are not available.

Source: Census and Statistics Department.

Economic and Financial Environment

Despite market concerns about the US Federal Reserve's plan to reduce asset purchases and volatile global financial conditions, the domestic money and foreign-exchange markets continued to operate smoothly. The Hong Kong dollar exchange rate remained stable amid mild fund flow pressures. Interbank interest rates stayed low, with small fluctuations occasionally arising from temporary liquidity needs. The longer-dated yields of the Exchange Fund paper followed their US dollar counterparts to trend up slightly, ending the year with a steeper Hong Kong dollar yield curve compared with a year ago. On the credit front, growth in total loans accelerated to 16% in 2013 from 9.6% a year earlier, spurred by strong demand for trade finance and US dollar loans. However, rises in deposits and broader monetary aggregates generally lagged behind. As a result, the loan-to-deposit ratio and particularly the US dollar ratio rose further in 2013. In view of the rise in loan growth, the HKMA introduced a Stable Funding Requirement that banks with higher rates of loan growth are required to maintain a specific level of stable funds in 2014.

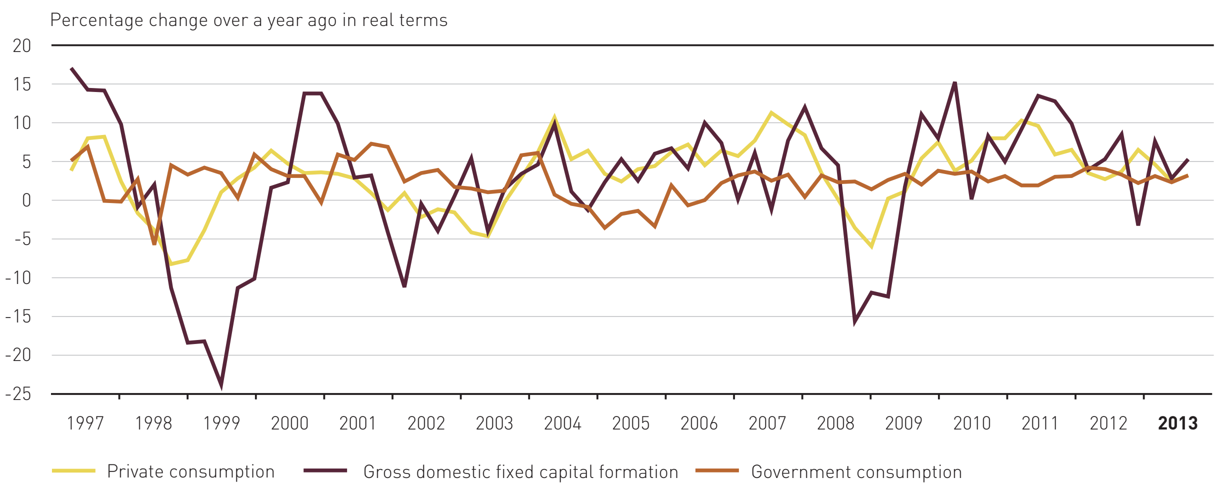
Domestic demand

Domestic demand held up in 2013 (Chart 2). On the back of still-favourable job conditions and higher incomes, private consumption grew by a solid 4.2%, similar to 2012. Growth in government consumption was steady at 2.7%. However, amid cautious business sentiment, gross domestic fixed capital formation expanded at a slower rate of 3.3%. While machinery and equipment investment maintained its growth momentum, private-sector building and construction activities continued to be a drag on overall investment growth. Public infrastructure works grew moderately after some years of strong growth.

External demand

Hong Kong's total exports improved gradually in 2013. Exports of goods grew faster by 6.7%, bolstered by rising intra-regional trade (Chart 3). However, overall external demand from the advanced markets remained weak, while that from Mainland China increased at a moderating pace along with the Mainland's slower economic growth. Underpinned by vibrant inbound tourism and a revival in stock market activities in the second half of the year, exports of services also rose at a faster pace of 5.8%. Growth in imports gathered pace on robust domestic demand and somewhat stronger export-induced demand. Overall, net exports reduced real GDP growth by 1.0 percentage points in 2013. In nominal terms, the overall trade balance was a surplus of $22.3 billion (1.1% of GDP) in 2013, compared with a surplus of $23.0 billion (1.1% of GDP) in 2012.

Chart 2 Domestic demand

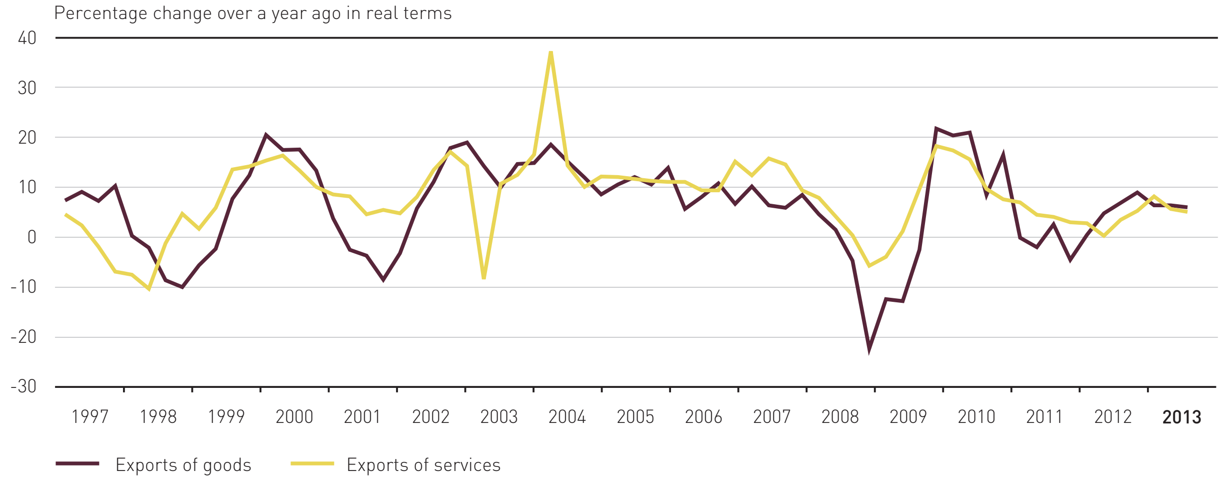


Source: Census and Statistics Department.

Inflation

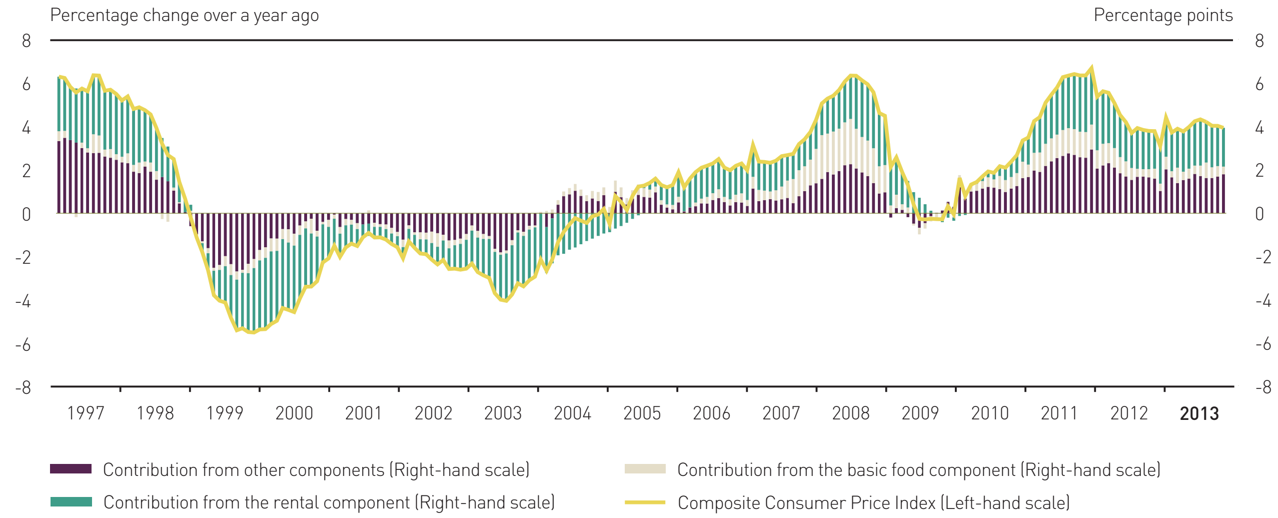
Inflationary pressures, while moderate, remained in 2013. Netting out the impact of the Government's one-off relief measures, the year-on-year underlying inflation rate hovered around 4% throughout the year, compared with an average of 4.7% in 2012 (Chart 4). The earlier increases in private housing rentals had fed through to the housing component of the Consumer Price Index, but towards the end of the year the impact of slower growth in fresh-letting private residential rentals began to set in. External price pressures were relatively weak, as shown in subdued imported inflation amid roughly stable international food and commodity prices. Labour costs increased steadily, reflecting a relatively tight labour market, while other non-tradable costs rose along with solid domestic demand.

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.

Economic and Financial Environment

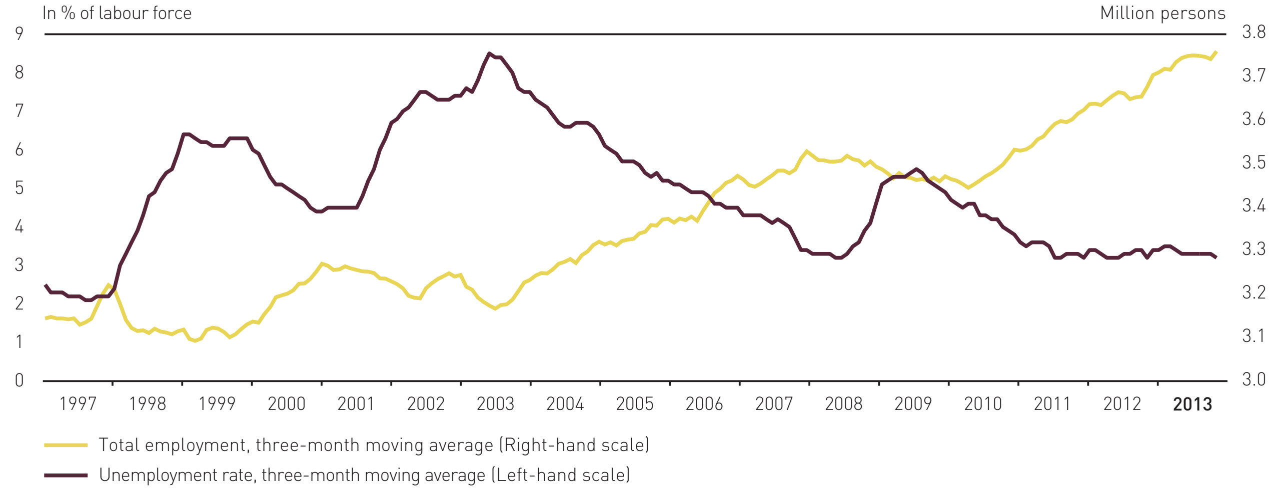
Labour market

Labour demand remained strong in 2013, with private-sector vacancies rising to a record high, due to stable economic growth, vibrant inbound tourism and a favourable hiring sentiment. Labour supply also increased, lured by robust job and income conditions. Taken together, total employment climbed to a new high towards the end of the year, while the unemployment rate and the underemployment rate hovered at low levels (Chart 5). Supported by the relatively tight labour market conditions, nominal wages and earnings continued to improve. In particular, sizable increases in average employment earnings for the lowest decile group were partly driven by the upward adjustment to the Statutory Minimum Wage rate that came into effect in May. The median monthly employment earnings also edged up.

Stock market

The Hong Kong stock market saw sharp fluctuations during the year along with a volatile external environment. Stock prices made a strong start in January and early February, but then experienced corrections amid renewed concerns over the euro area sovereign debt crisis and uncertainties in the US Federal Reserve's plan of reducing the size of the asset purchase programme. After a brief respite, market sentiment turned negative again amid the financial turmoil in emerging markets in August. In the fourth quarter, there were further fluctuations relating to the US Federal Reserve's announcement to begin reducing asset purchases and a rise in Mainland China's macro-financial risk. Overall, the Hang Seng Index gained a modest 2.9% in 2013 and closed at 23,306 on 31 December (Chart 6). The average daily turnover of the stock market

Chart 5 **Labour market conditions**



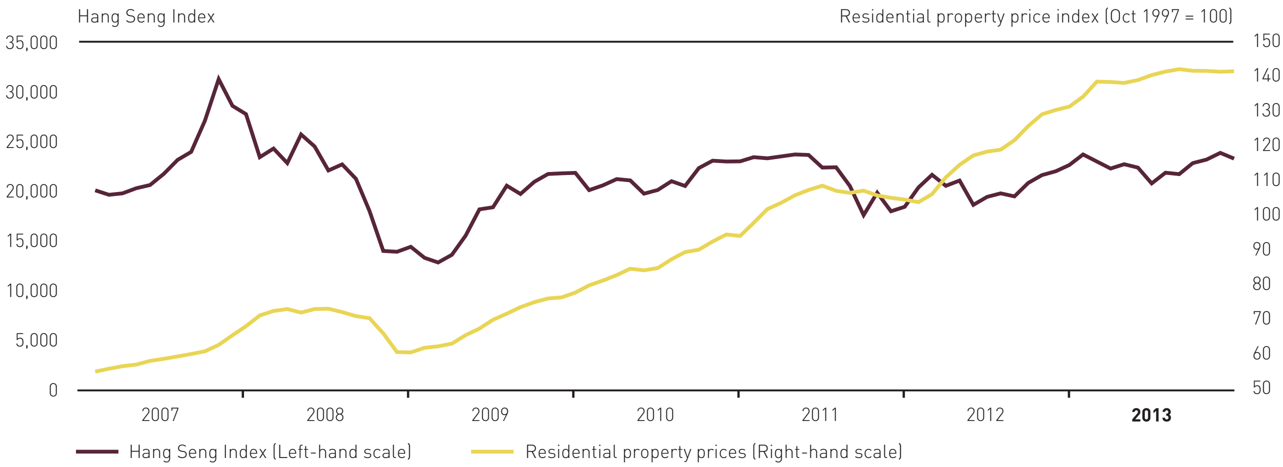
Source: Census and Statistics Department.

trended downwards, while the value of short-selling transactions increased. The year saw a revival in equity fund-raising activities, especially in the last four months. For the year as a whole, total funds raised from the market picked up to $378.9 billion from $305.4 billion in 2012.

Property market

The once-buoyant property market experienced a period of consolidation in 2013, particularly after the HKMA and the Government further tightened the prudential and stamp duty measures in late February. Residential property price inflation had since softened (Chart 6). Market activity was also sluggish, with the monthly average transaction volume falling to 4,200 from 6,800 in 2012. Speculative transactions almost vanished as reflected in a sharp decline in confirmor transactions and short-term flipping trades. Nevertheless, residential property valuations remained highly stretched, as the price-to-income ratio of 14.5 had already reached its 1997 peak and the income-gearing ratio remained far above its historical average. Commercial and industrial property markets also became less buoyant, as evidenced by their moderating price inflation and shrinking transaction volume. The overall rental yields stayed near the historical low for the entire year.

Chart 6 Asset prices



Sources: Rating and Valuation Department, and CEIC.

Economic and Financial Environment

OUTLOOK FOR THE ECONOMY

Economic environment

The Hong Kong economy is expected to grow moderately faster in 2014. As the advanced economies gradually regain ground and Mainland China's economy remains broadly resilient, external demand is likely to improve. On the domestic front, private consumption is likely to grow at a moderate pace with the support of still-positive consumer confidence, stable labour market conditions and spillovers of global trade recovery, although there will be some offsets from the less favourable wealth effect from potentially weaker asset markets. Ongoing infrastructure works, a pick up in private sector building and construction activities, as well as a sustained increase in machinery and equipment acquisition, thanks to an improving business outlook, will also contribute to GDP growth. For 2014, private sector analysts project the economy to expand by 2.8 – 4.0%, averaging at 3.5%, and the Government sees GDP growth strengthening in the range of 3.0 – 4.0%.

Inflation and the labour market

Consumer price inflation is expected to moderate slightly in 2014. In particular, slower increases in fresh-letting housing rentals in 2013 will continue to feed through and contain domestic price pressures. At the same time, a stable outlook for food and international commodity prices will also keep external price pressures in check. Market consensus predicts headline inflation at 3.8% in 2014, slightly lower than the 4.3% in 2013. The outlook for the labour market is stable, largely reflecting steady economic expansion and generally positive hiring sentiment. The unemployment rate is projected to stay at a relatively low level of around 3.4%, according to the consensus forecasts.

Uncertainties and risks

The relatively favourable outlook for the Hong Kong economy is subject to a number of uncertainties and risks. On the downside, the predominant external risk comes from the still-uncertain pace and scale of the US Federal Reserve's reduction of asset purchases and interest rate normalisation. Any significant adverse developments could aggravate volatilities in financial markets, fund flows and liquidity, and overshadow Hong Kong's growth prospects through the trade and financial channels. Elsewhere, slower-than-expected growth in Mainland China could cause negative spillovers to Hong Kong given the increasingly close economic relations between the two economies. Domestically, the property market is prone to downward pressures against the background of eventual interest rate hikes. Should the market react unfavourably to the US Federal Reserve's monetary actions or there is a significant reversal of fund flows, it could exacerbate downward adjustments in property prices, thereby threatening broader macroeconomic adjustments and asset price corrections. On the upside, a better-than-expected economic performance of the advanced economies and the Mainland's economy could lift global growth and international trade flows, thereby raising Hong Kong's external demand and boosting consumption expenditure, perhaps through improved consumer sentiment.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector performed well in 2013, despite the US debt ceiling crisis and the uncertainties over the pace of the US Federal Reserve's tapering of its quantitative easing measures. Asset quality and liquidity positions of retail banks remained sound, and locally incorporated authorized institutions (AIs) continued to be well capitalised. Credit growth in the banking sector slowed in the fourth quarter.

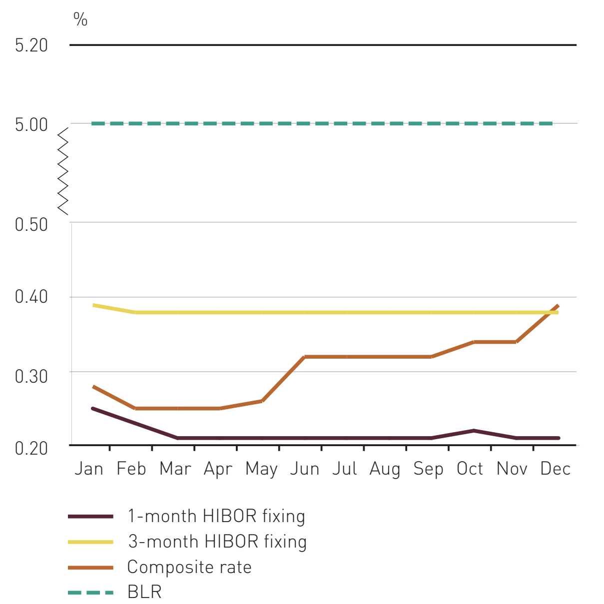
Interest rate trends

The accommodative policy stance persisted in the major advanced economies to spur economic growth during 2013. In line with the US dollar interest rates, Hong Kong dollar interbank interest rates remained relatively low throughout the year. However, the composite interest rate, which reflects the average cost of funds for retail banks, rebounded since May from its previous low level (Chart 7). This coincided with the announcement also in May that the US Federal Reserve envisaged phasing out its quantitative easing policy.

Profitability trends

The aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 22.1% in 2013, mainly due to the growth in net interest income by 13.0% and non-interest income by 15.2%. As post-tax profit grew at a much faster pace than that of the average assets, the post-tax return on average assets of retail banks increased to 1.40% in 2013 from 1.06% a year earlier (Chart 8).

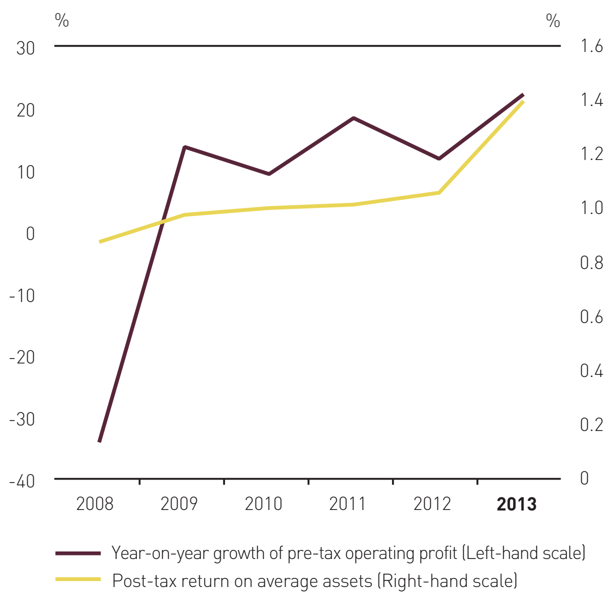
Chart 7 **HIBOR fixings, composite rate and best lending rate (BLR)**



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

Chart 8 **Retail banks' performance**



Retail banks' net interest margin (NIM) widened to a yearly average of 1.40% in 2013 from 1.36% in 2012 as a result of lower funding costs compared with a year ago (Chart 9).

Driven by the growth in income from foreign exchange and derivatives operations, as well as income from fees and commissions, retail banks' non-interest income as a share of total operating income rose slightly to 46.7% from 46.3% in 2012.

The operating costs for retail banks increased by 5.2%, partly caused by rising rental and staff expenses. Nevertheless, the cost-to-income ratio decreased to 42.2% in 2013 from 45.8% in 2012 as the growth in operating income outpaced that of operating costs during the period (Chart 10).

The net charge for debt provisions rose to $3.6 billion in 2013 from $3.5 billion a year ago. Despite the increase, the provisions remained at a relatively low level, reflecting the sound quality of retail banks' loan book.

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

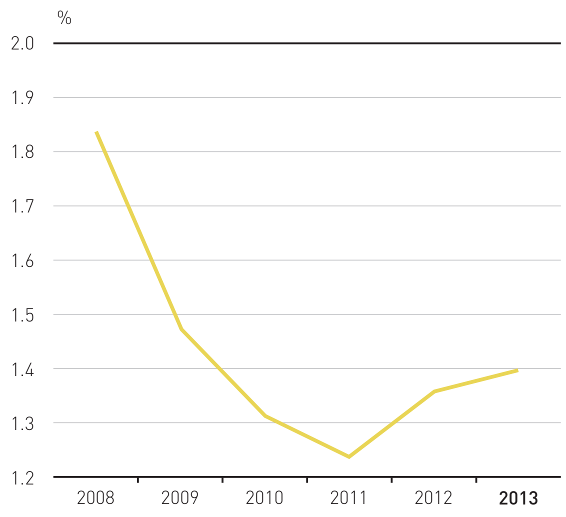
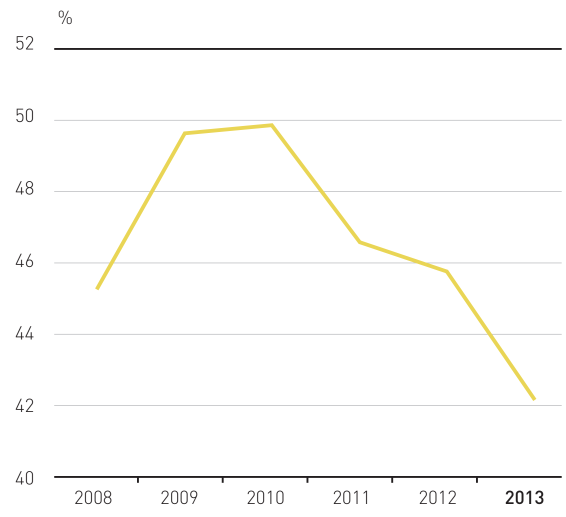


Chart 10 **Retail banks' cost-to-income ratio**



Asset quality

The asset quality of retail banks remained robust in 2013. The classified loan ratio was maintained at a low level of 0.48% at the end of the year. The combined ratio of overdue and rescheduled loans reduced to 0.33% compared with 0.39% a year earlier (Chart 11).

The quality of surveyed institutions' residential mortgage lending remained sound, with the delinquency ratio staying at a record low of 0.02% at the end of 2013 (Chart 12). The rescheduled loan ratio edged down to nearly 0% from 0.01% in 2012. The surveyed institutions reported 26 cases of residential mortgage loans in negative equity at the end of the year, compared with no cases at the end of 2012.

The delinquency ratio of credit card portfolios remained stable at 0.20% at the end of 2013 compared with a year earlier (Chart 12). The combined delinquent and rescheduled ratio rose slightly to 0.27% from 0.26%, while the charge-off ratio increased to 1.84% from 1.70% in the same period. Despite the increases, these ratios were still low by historical standards.

Chart 11 **Asset quality of retail banks**

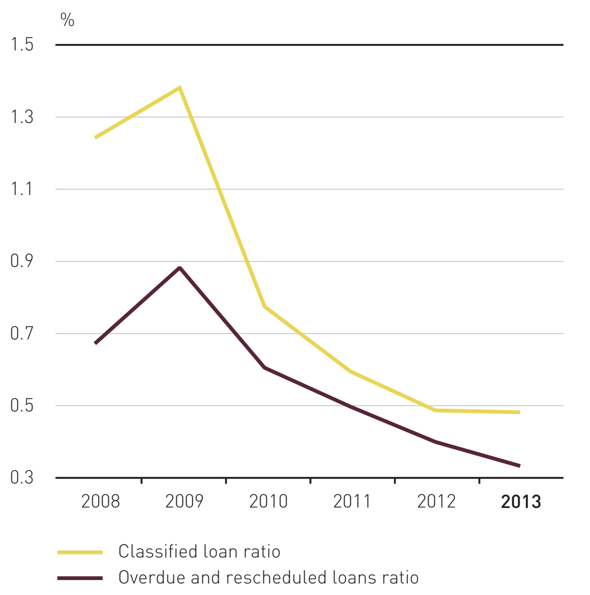
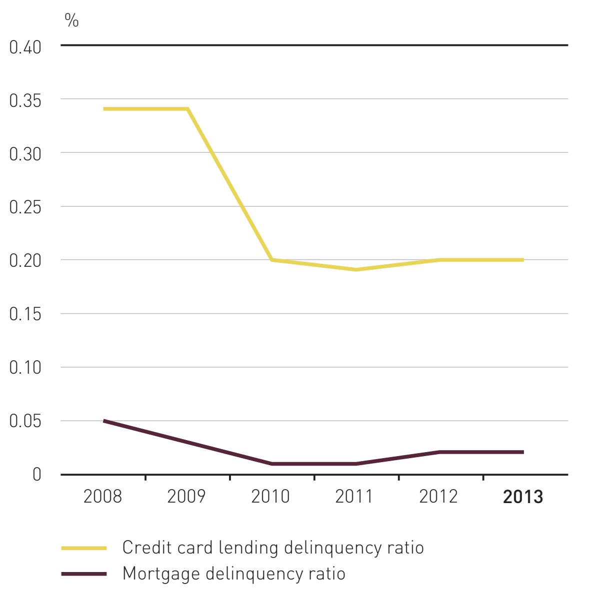


Chart 12 **Delinquency ratios of residential mortgages and credit card lending of surveyed institutions**



Economic and Financial Environment

Balance sheet trends

Total loans and advances of retail banks grew by 14.6% in 2013, while total deposits rose by 11.7%. As a result, the overall loan-to-deposit ratio of retail banks increased to 56.3% from 54.8% in 2012. The Hong Kong dollar loan-to-deposit ratio also rose to 74.8% from 72.3% a year ago (Chart 13).

For the banking sector as a whole, credit growth accelerated from 9.6% in 2012 to 16.0% in 2013. The rate of growth in trade financing and loans for use outside Hong Kong continued to outpace that for loans for use in Hong Kong. The increase in loans for use in Hong Kong was mainly led by property lending, lending to wholesale and retail sectors and financial concerns. In view of the high credit growth in the banking sector in the first three quarters of 2013 (19.9% on an annualised basis), the HKMA wrote to banks with rapid loan growth informing them of the Stable Funding Requirement to be implemented in 2014. Credit growth slowed in the fourth quarter (3.6% on an annualised basis).

Retail banks' total non-bank Mainland exposures[1] rose to $2,279 billion at the end of 2013 from $1,779 billion a year ago. For the banking sector as a whole, non-bank Mainland exposures increased to $3,602 billion from $2,739 billion in 2012.

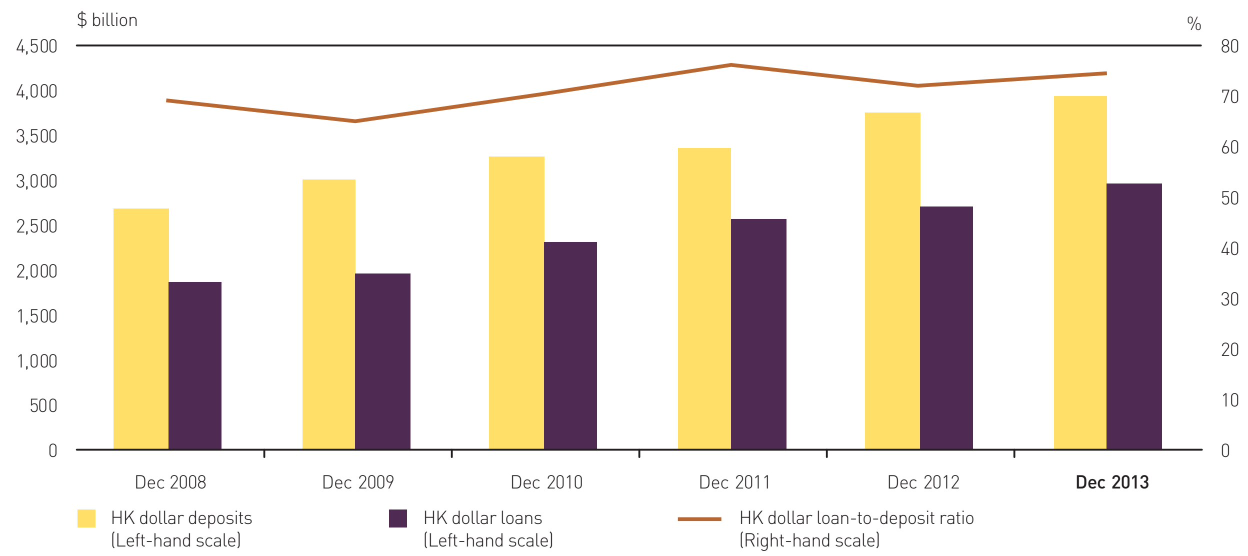
Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, increased by 17.5% in 2013. The share of total holdings of NDIs relative to total assets rose to 25% at the end of the year from 24% at the end of 2012. Among the holdings of NDIs, 43% were government-issued (49% in 2012), 28% were issued by non-bank corporates (29% in 2012), and 29% were issued by banks (22% in 2012) (Chart 14).

Capital adequacy and liquidity

All locally incorporated AIs remained well capitalised. The consolidated capital adequacy ratio of all locally incorporated AIs rose to 15.9% at the end of 2013 from 15.7% a year earlier (Chart 15). The increase was due to faster growth in the capital base than in the risk-weighted amount. The Tier-1 capital adequacy ratio remained unchanged at 13.3% in the same period.

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



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

As a result of the average qualifying liabilities rising faster than the average liquefiable assets, the average liquidity ratio of retail banks decreased from 42.6% in the final quarter of 2012 to 39.6% in the same period of 2013. Despite the decrease, the quarterly average liquidity ratio is still well above the statutory minimum of 25% (Chart 16).

Chart 14 **Retail banks' holdings of negotiable debt instruments at the end of 2013 (counterparty breakdown)**

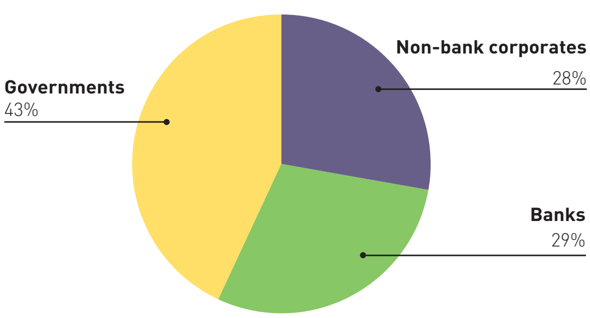


Chart 15 **Consolidated capital adequacy ratio of locally incorporated AIs**

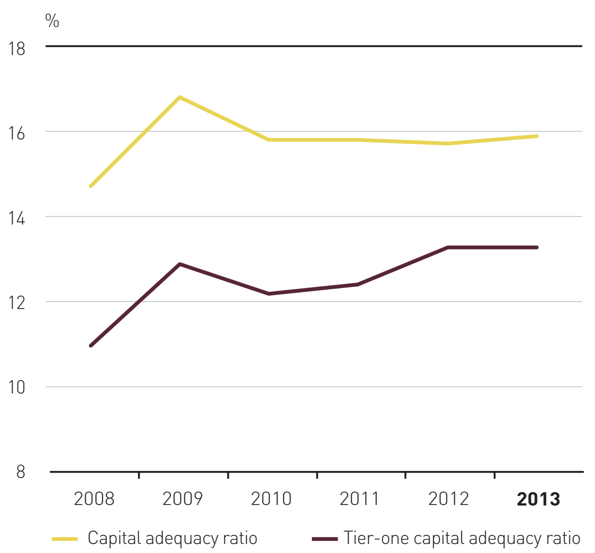
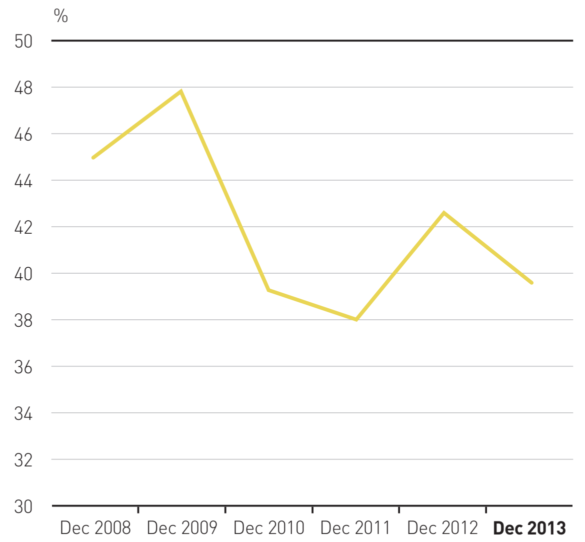


Chart 16 **Retail banks' liquidity ratio (quarterly average)**



PROSPECTS FOR 2014

The US started to reduce its monthly asset purchases from January 2014. This marked the beginning of the normalisation of US monetary conditions, which will inevitably heighten market volatility especially in emerging markets. The pace of further reductions and when the asset purchase programme may cease also remain uncertain. All these will pose potential risks for worsening liquidity conditions and fund outflows. So far, there has been no noticeable impact on Hong Kong's banking sector. Nevertheless, the HKMA has cautioned banks to enhance the resilience of their liquidity and interest rate risk management to cater for possible fund outflows or an abrupt rise in interest rates. With the high credit growth in 2013, banks are also reminded to exercise prudence in managing credit risk and are required to use stable funding to support their rapid credit growth.

Monetary Stability

Despite a volatile global financial environment and concerns about the US Federal Reserve's plan to reduce asset purchases, the Hong Kong dollar exchange rate remained stable in 2013, while the money market operated smoothly with abundant liquidity. The Linked Exchange Rate system continued to serve as the anchor for Hong Kong's monetary and financial stability and proved highly resilient in a series of regional and global financial crises.

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 2013**	31 December 2012
Certificates of Indebtedness[1]	**329,325**	291,675
Government-issued currency notes and coins in circulation[1]	**10,638**	9,997
Balance of the banking system	**164,093**	255,851
Exchange Fund Bills and Notes (EFBN) issued [2]	**751,850**	661,396
TOTAL	**1,255,906**	1,218,919

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 2013

Exchange rate stability

The Hong Kong dollar exchange rate traded within a tight range between 7.7509 and 7.7646 against the US dollar (Chart 1). After strengthening close to the strong-side CU in late 2012, the Hong Kong dollar exchange rate eased back slightly in the first half of 2013 amid weaker equity-related demand on market concerns about the reduction of asset purchases by the US Federal Reserve and a slowdown in Mainland China's economy. But from mid-June onwards, despite a confluence of concerns about the US Federal Reserve reducing asset purchases, a liquidity squeeze on the Mainland and sell-offs in emerging market currencies, there were mild fund flows into the Hong Kong dollar, resulting in a slight strengthening in the Hong Kong dollar exchange rate. Following the December announcement by the US Federal Open Market Committee of its decision to reduce asset purchases, there was no significant weakening in the Hong Kong dollar exchange rate which continued to stay close to the strong-side CU.

During the year, the CU was not triggered and the HKMA did not conduct any foreign exchange operations within the Convertibility Zone, leaving the total Aggregate Balance and outstanding Exchange Fund Bills and Notes virtually unchanged at around $916.0 billion. In response to market demand, the HKMA issued a total of $92.0 billion in additional Exchange Fund Bills in the first half of 2013. The Aggregate Balance contracted accordingly to $163.9 billion in early June and stabilised at around this level for the remainder of the year (Chart 2). As the additional issuance of Exchange Fund paper represented a change in the composition of the Monetary Base, these operations were consistent with Currency Board principles, with the Monetary Base fully backed by the foreign exchange reserves.

Chart 1 Market exchange rate in 2013

Money market

Interbank liquidity remained abundant despite a volatile global financial environment and concerns about the US Federal Reserve reducing its asset purchases. The Hong Kong dollar interbank interest rates remained at very low levels during 2013, although they edged modestly higher over the course of the year with occasional fluctuations stemming from banks' funding demand for quarter-end liquidity management and intense equity fund-raising activities (Chart 3). For the whole year, the short-dated interbank rates continued to hover below the Base Rate of 0.5%. Discount Window borrowing was not active and amounted to only $5.1 billion in 2013. The Hong Kong dollar forward market also operated orderly and smoothly, with the Hong Kong dollar forward points closely following the movements in the HIBOR-LIBOR spreads.

Chart 2 **Aggregate Balance and outstanding Exchange Fund paper in 2013**

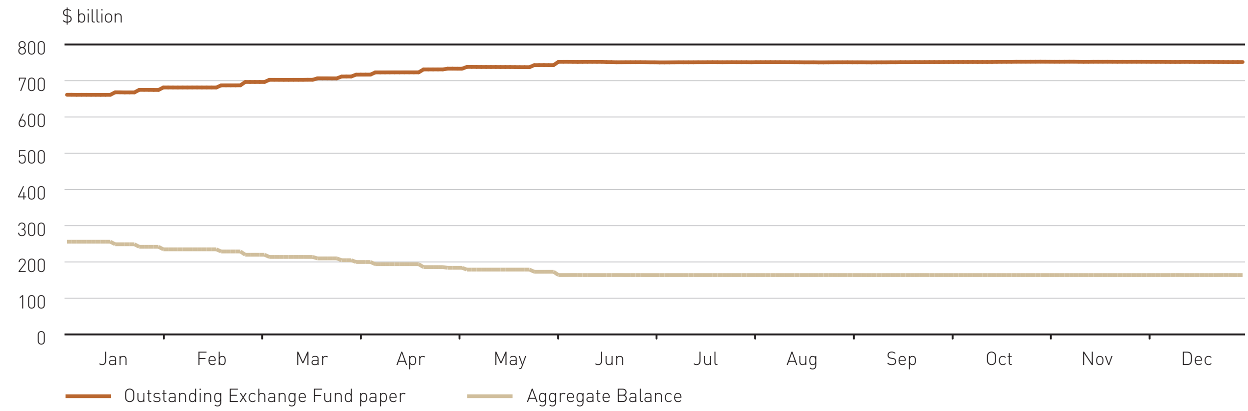
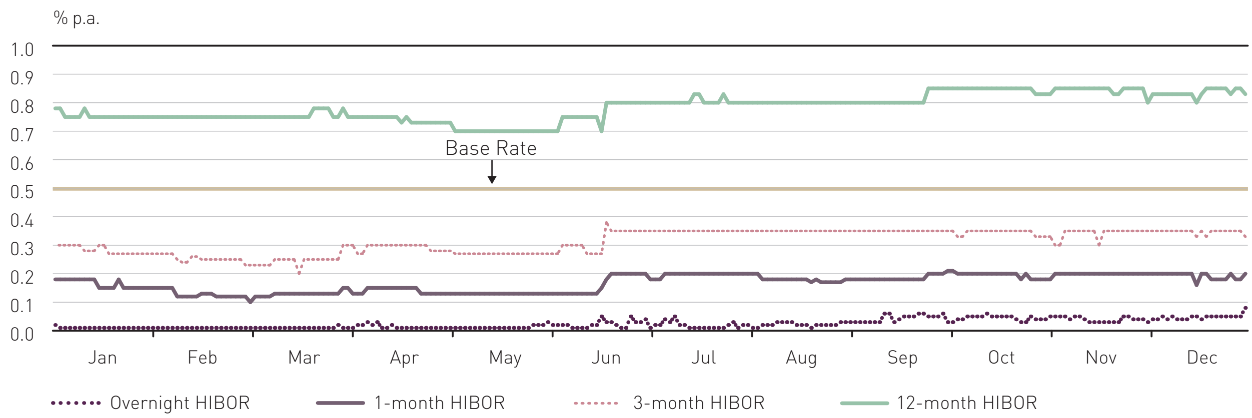


Chart 3 **Hong Kong dollar interbank interest rates in 2013**



The Linked Exchange Rate system

Over the past three decades, the Linked Exchange Rate system has served as the anchor for Hong Kong's monetary and financial stability and has proved highly resilient in a series of regional and global financial crises. The LERS was also strongly endorsed by the International Monetary Fund (IMF) in its annual Article IV consultation with Hong Kong as a simple, credible, transparent and widely understood exchange rate system that has contributed immensely to the maintenance of Hong Kong's monetary and financial stability. To mark the system's 30th anniversary in 2013, the Hong Kong SAR Government reiterated its full commitment to the LERS, with the HKMA reaffirming the merits of the system in an inSight article and publishing a set of Frequently Asked Questions to help the public develop a better understanding of the LERS.[1] The HKMA also illustrated that there continued to be very strong public confidence in the Hong Kong dollar as a means of payment and storage of value, with no signs or evidence of the currency being "marginalised" by the rise of the renminbi.[2]

A sound banking system is crucial to the normal functioning of the LERS. During 2013, the HKMA continued to monitor closely banks' management of credit and liquidity risks, property-related lending and stress-testing to ensure the resilience of the banking sector.

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 107-108% during 2013, without touching the Upper or Lower Trigger Level. The ratio closed at 107.4% 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 provides a powerful backstop in protecting Hong Kong's monetary and financial stability.

Chart 4 Daily movement of the Backing Ratio in 2013

[1] Chan, Norman T.L. "The Linked Exchange Rate System – 30 Years On", *inSight*, 14 October 2013, http://www.hkma.gov.hk/eng/key-information/insight/20131014.shtml.

[2] Chan, Norman T.L. "Foreign exchange turnover involving the Hong Kong dollar and Hong Kong dollar marginalisation", *inSight*, 13 September 2013, http://www.hkma.gov.hk/eng/key-information/insight/20130913.shtml.

Other activities

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2013, the Sub-Committee considered issues including the liquidity and depth of the Hong Kong dollar exchange market, the risk in the US bond market and likely contagion impact on Hong Kong, the influence of the renminbi on Asian currencies, and the dynamics of the Hong Kong dollar-US dollar interest rate differentials and fund flows. 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. During the year, it hosted 22 research fellows and published 25 working papers. The Institute also organised seven international conferences and workshops. The main ones included:

- The Fourth Annual International Conference on the Chinese Economy in January with the theme "The Role of Financial System Reforms in Rebalancing the Chinese Economy". The conference covered a wide range of issues, such as China's economic growth, the lending behaviour of state-owned banks, financial system reforms and China's monetary policy, renminbi internationalisation, and the impact of labour market development on wages

- The HKMA Symposium on Financial Stability in May, which dealt with issues related to financial stability, including the interactions between micro- and macro-prudential policies, the role of rule and discretion in financial stability policy-making, the efficient and effective governance arrangements for financial stability policies, and the pros and cons of different institutional arrangements

- The "HKMA 20th Anniversary Research Workshop" in June, designed to celebrate the HKMA's 20th anniversary and featured research papers on the Hong Kong economy by HKMA staff. Major economic issues covered included the recent performance of the Hong Kong dollar foreign exchange market, the current account balance of Hong Kong, the Mainland exposure of Hong Kong banks, the demand and supply of mortgage loans and the role of loan-to-value ratio policy, and the development of the renminbi market in Hong Kong

- The 36th Pacific Trade and Development Conference in December with the theme "Financial Development and Co-operation in Asia and the Pacific". The conference examined issues affecting these economies, including financial reform and liberalisation, monetary policy frameworks, capital market developments, financial developments in Mainland China and their implication for the global economy, and prudential regulation and supervision in the region.

The Institute co-hosted a conference on macroeconomics and international finance with the Hong Kong University of Science and Technology and the Eleventh HKIMR Summer Workshop on property markets with the Chinese University of Hong Kong. Moreover, it held the eleventh HKIMR conference on the Mainland economy focusing on the offshore renminbi market. The conferences and workshops were attended by participants from academia, the financial services industry and global central banks. In addition, the Institute held 35 public seminars on a broad range of economic and monetary issues.

Notes and coins

At the end of 2013, the total value of banknotes in circulation was $329.3 billion, an increase of 12.9% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to $10.4 billion, up 6.6% (Charts 8 and 9). The value of $10 notes issued by the Government in circulation reached $3.8 billion, of which 68% were polymer notes.

Chart 5 **Banknotes in circulation by note-issuing banks at the end of 2013**

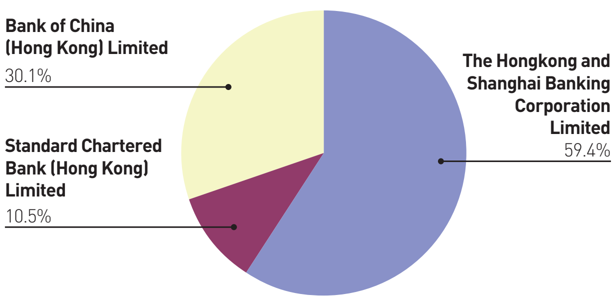
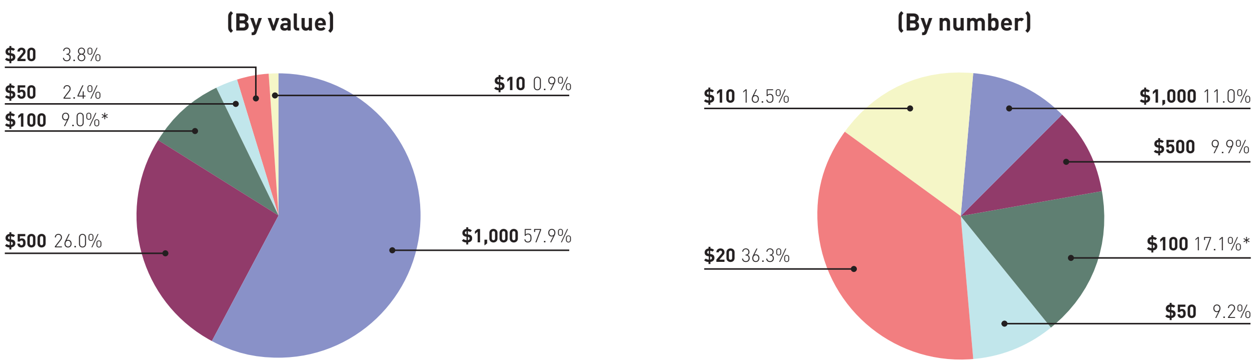


Chart 6 **Distribution of banknotes in circulation at the end of 2013**



* Includes 0.1 percentage point contributed by $150 banknotes.

Chart 7 Banknotes in circulation at the end of 2013

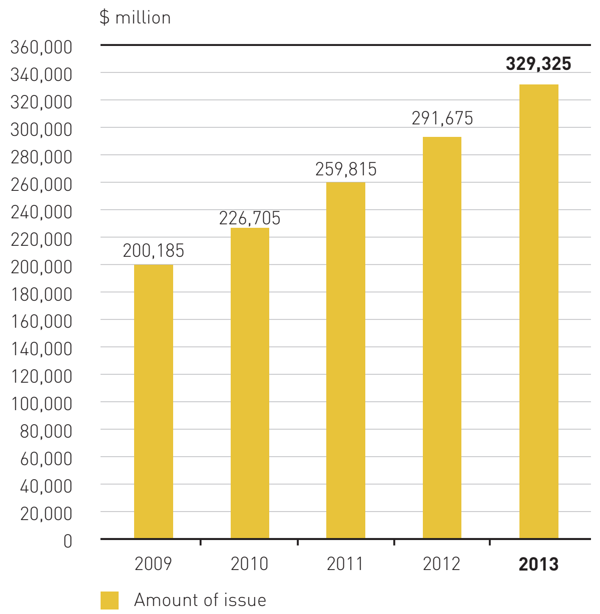


Chart 8 Government-issued notes and coins in circulation at the end of 2013

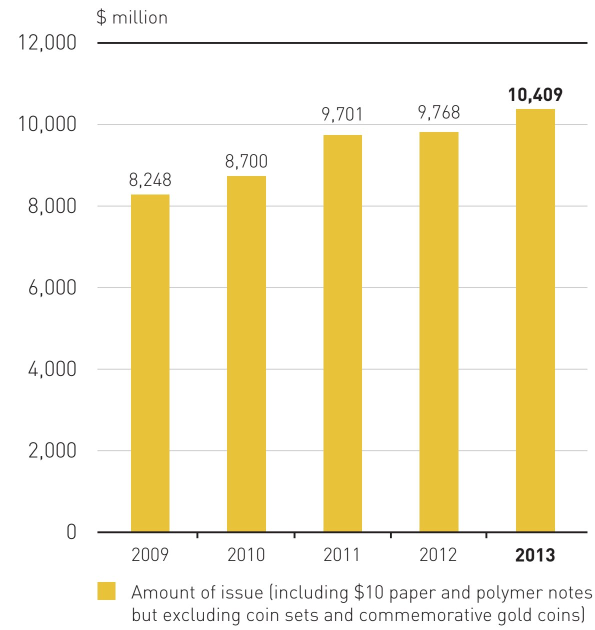
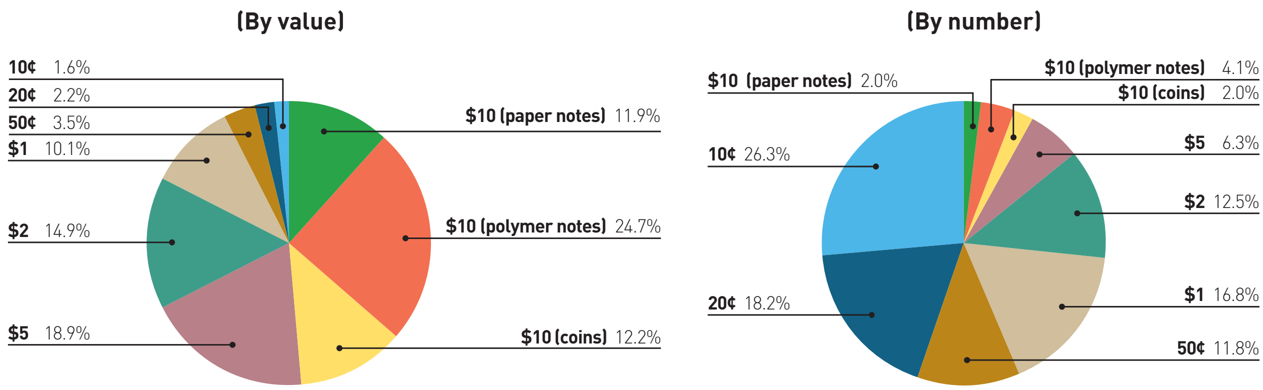


Chart 9 Government-issued notes and coins in circulation at the end of 2013



Hong Kong banknotes

The latest series of banknotes, issued in 2010 by the three note-issuing banks, is incorporated with advanced security features to stay ahead of counterfeiters. Public education programmes to promote awareness of the designs and security features of Hong Kong banknotes continued to be well-received.

The counterfeit banknotes incident at the end of 2013 further demonstrated the importance for the HKMA to be able to act promptly and effectively on matters that could potentially affect Hong Kong's monetary stability. The HKMA responded swiftly to the surfacing in December of two good quality counterfeit notes of the 2003 series $1,000 banknote. It issued clear advice to the public on how to identify the counterfeit notes with the aid of press releases and a joint press conference with the Police. Detailed information on the characteristics of the counterfeit notes, including videos, were posted on the HKMA website, attracting over 500,000 views. Within the space of one month, the HKMA also held 33 seminars on banknote security features for more than 7,000 participants from the banking sector and major retailers. After the training sessions, the participants indicated they were much more confident of identifying the counterfeit notes.

The HKMA requested the banks to speed up the withdrawal of the 2003 series $1,000 banknotes, and reassured the public that all notes dispensed by tellers over the counter or through automated teller machines were duly authenticated and genuine. The HKMA also worked closely with the Police and the banking sector to enhance the capability of the banks' cash deposit machines to detect counterfeit notes.

Exchange Fund Bills and Notes

A total of $92 billion worth of additional Exchange Fund Bills were issued in 2013, alongside an increase in demand for these papers after repeated triggering of the strong-side CU in the final quarter of 2012 led to an expansion in the Aggregate Balance. The additional issuance covered the two benchmark tenors of 91 and 182 days. Outstanding Exchange Fund Bills increased to $683 billion. In addition, the HKMA maintained the regular issuance programme for the Exchange Fund Notes. At the end of 2013, the amount of outstanding Exchange Fund Bills and Notes stood at $751 billion (Table 2).

Table 2 Outstanding issues of Exchange Fund Bills and Notes

$ million	**2013**	2012
Exchange Fund Bills (by original maturity)		
28 days	**0**	600
91 days	**399,851**	350,884
182 days	**241,000**	195,000
364 days	**42,200**	42,200
Sub-total	**683,051**	588,684
Exchange Fund Notes (by remaining tenor)		
1 year or below	**15,800**	17,000
Over 1 year and up to 3 years	**25,300**	25,900
Over 3 years and up to 5 years	**11,200**	11,200
Over 5 years and up to 10 years	**9,800**	8,600
Over 10 years	**6,000**	6,000
Sub-total	**68,100**	68,700
Total	**751,151**	657,384

PLANS FOR 2014 AND BEYOND

While the advanced economies have shown signs of continued recovery, the global financial environment is expected to be challenging in 2014. In particular, the US Federal Reserve's decision to begin reducing its monthly asset purchases from January 2014, together with the still-uncertain pace of asset purchases reduction and interest rate normalisation ahead, could increase the volatility in fund flows and the risk of fund flow reversals for Hong Kong. For example, a faster-than-expected normalisation process could lead to global re-pricing of market risks and shifts in asset allocation. This could cause significant outflow pressure on Hong Kong and a contraction in banks' liquidity, thereby weighing on domestic asset prices and the domestic economic outlook. On the other hand, any undue delays in the Federal Reserve's exit that included keeping the ultra-loose monetary conditions for much longer could well support market sentiment and pose further risks to asset price inflation and the macro-financial stability of Hong Kong.

The HKMA will continue to closely monitor risks and vulnerabilities in the domestic and external environment and stand ready to deploy appropriate measures, where necessary, to maintain monetary and financial stability in Hong Kong. Research programmes for the coming year will study issues affecting the Hong Kong 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 prospect of asset purchases reduction in the US brought about volatility in financial markets in 2013, highlighting market concerns over possible deterioration of liquidity conditions and fund outflows. To guard against the potential adverse impact on the banking sector, the HKMA continued to take proactive steps to ensure banking stability. During the year, the sixth round of prudential measures on property mortgage loans was introduced. A Stable Funding Requirement was introduced to ensure loan growth by authorized institutions (AIs) is supported by sufficient stable funds. The HKMA also stepped up its supervision of Mainland-related business and anti-money laundering controls. The year also saw the implementation of the first phase of the Basel III capital standards and the associated disclosure requirements. To enhance consumer protection, the HKMA also rolled out a consumer education programme and launched the Treat Customers Fairly Charter.

REVIEW OF 2013

Overview

Amid uncertainties over fiscal issues and economic recovery in the US and Europe, volatilities in emerging markets and increased risk in the local property market, the HKMA continued to monitor closely AIs' management of credit and liquidity risks, Mainland-related business, property-related lending and stress-testing to ensure the resilience of the banking sector against any abrupt changes in the macroeconomic environment.

Operational supervision

In 2013, the HKMA carried out 282 on-site examinations. Resources were also deployed to work related to the International Monetary Fund's (IMF) assessment of the HKMA's compliance with the *Core Principles for Effective Banking Supervision* under the Financial Sector Assessment Programme (FSAP), as well as more in-depth thematic examinations of AIs' Mainland-related activities given their increased significance and the systemic risk they could pose to the Hong Kong banking sector. The HKMA also conducted thematic examinations of property-related lending and asset quality. Based on the examination scope determined for individual AIs, risk-based examinations reviewed, as appropriate, AIs' general credit and operational risk management, the adequacy and effectiveness of their compliance, legal and internal audit functions, corporate governance and remuneration systems.

The HKMA conducted more on-site examinations of the effectiveness of AIs' risk management and regulatory compliance in specialised areas compared with 2012, such as stress-testing and liquidity risk, prevention of money laundering and terrorist financing and technology and operational risk. AIs' activities in securities, investment products, insurance and Mandatory Provident Fund-related businesses were also subject to on-site examinations by specialist teams during the year. Details of specialised examinations are given in the subsequent sections.

The HKMA also continued to conduct on-site reviews of the redeveloped internal models of AIs which have been given approval to adopt the Foundation or Advanced Internal Ratings-based (IRB) approach for calculating credit risk capital charge.

One hundred and ninety-three off-site reviews were conducted to assess AIs' financial position and business operations. Supervisory attention focused on AIs' credit growth, in particular cross-border trade finance activities, and the associated impact on asset quality, liquidity and funding positions. The supervisory teams maintained contact with the boards of directors and external auditors of selected AIs. Meetings were held with the full board or board-level committees of 15 AIs and tripartite meetings with the senior management and external auditors of nine AIs.

The Banking Supervision Review Committee considered seven cases, four concerning authorization of AIs, two relating to the investigation of conduct issues of AIs arising from banking operations other than regulated activities, and one relating to an application to become a shareholder controller of an AI.

To better utilise its supervisory resources on competing priorities, the HKMA made increased use of powers under section 59(2) of the Banking Ordinance to require AIs to appoint external auditors to follow-up on potentially material supervisory issues. The HKMA commissioned seven reports under this provision in 2013. Four of these reports covered anti-money laundering and counter-terrorist financing (AML/CFT) control systems and the remaining three were related to other control issues, such as operational risk management, governance frameworks and securities-related activities.

No AI breached the requirements of the Banking Ordinance relating to capital adequacy in 2013. There was one breach of the requirement under section 102 relating to the liquidity ratio, 11 under section 20(4)(b) on notification to the HKMA of a change to information recorded in the register maintained by the HKMA, three under section 65 on notification to the HKMA of alterations to memorandum or articles of association, three under section 72A(2A) on notification to the HKMA of a change of specified persons within 14 days, and three under section 72B on notification to the HKMA of the appointment of managers. All the breaches were assessed to be unintentional. They were rectified promptly by the relevant AIs and did not affect the interests of depositors.

Table 1 Operational supervision

		2013	2012
1	On-site examinations	**282**	288
	Regular examinations	**56**	73
	– risk-based	**47**	58
	– overseas	**9**	15
	Reviews of the internal ratings-based approach (IRB approach) and internal models approach (IMM approach)	**12**	22
	– Initial recognition assessment and follow-up examinations of the IRB approach	**9**	15
	– Recognition of major system changes and follow-up examinations of the IMM approach	**3**	7
	Capital planning	**4**	7
	Credit risk management and asset quality	**33**	34
	Market risk and treasury activities	**2**	9
	Firm-wide stress testing and liquidity risk management	**41**	13
	Securities, investment products, insurance and Mandatory Provident Fund-related businesses	**24**	27
	Compliance with the Deposit Protection Scheme Ordinance and Deposit Protection Scheme Representation Rules	**12**	12
	Code of Banking Practice/Consumer Protection	**3**	2
	Positive mortgage data sharing	**2**	3
	Anti-money laundering/counter-terrorist financing controls	**19**	14
	IT, Internet banking and operational risk	**40**	20
	Mainland-related business	**31**	15
	Renminbi business	**3**	37
2	Off-site reviews and prudential interviews	**193**	192
3	Tripartite meetings	**9**	13
4	Meetings with board of directors or board-level committees of AIs	**15**	19
5	Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs	**225**	199
6	Reports commissioned under section 59(2) of the Banking Ordinance	**7**	1
7	Cases considered by the Banking Supervision Review Committee	**7**	7
8	AIs subject to the exercise of powers under section 52 of the Banking Ordinance	**1**	1

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 the year. 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 use of Internet banking services continued to grow in 2013. By the end of the year, the number of personal Internet banking accounts reached 8.8 million (from 8.4 million in 2012), and there were 788,000 corporate Internet banking accounts (up from 764,000 in 2012).

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 independent compliance assessment (formerly called supervisory control self-assessment) process for Internet banking, technology risk management and business continuity planning was extended to 90 AIs (from 79 in 2012). The HKMA also conducted desktop reviews and thematic examinations of 61 AIs to assess the adequacy of their independent compliance assessment processes.

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

The HKMA continued to monitor the industry's implementation of chip-based ATM technology to strengthen security controls for ATM services. All ATM terminals in Hong Kong have been upgraded to support chip-based authentication and ATM card replacement will be completed in phases by the end of 2015. Continued efforts were also made to increase public awareness of the new ATM security measures through the Consumer Education Programme launched by the HKMA in late 2013.

Public awareness of Internet banking security was again featured in the HKMA's promotional efforts in collaboration with other entities. This included participating in the "Build a Secure Cyberspace" campaign organised by the Hong Kong Police Force, the Office of the Government Chief Information Officer and the Hong Kong Computer Emergency Response Team Co-ordination Centre to raise awareness of cyber threats and highlight the importance of information security.

Supervision of operational risk

The annual self-assessment on operational risk management covered 78 AIs in 2013 (74 in 2012). In general, the exercise showed the AIs concerned had established operational risk management frameworks in line with the supervisory requirements. A specialist operational risk management team conducted on-site examinations at three AIs to review their policies and controls on operational risk.

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

Throughout the year, 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' businesses related to securities, insurance and Mandatory Provident Fund (MPF). Regular contact was maintained through bilateral and multilateral meetings, and under the auspices of the Council of Financial Regulators.

Because of the low interest rate environment, yield enhancement products such as high-yield bonds and high-yield bond funds have become popular among investors. As a result, the HKMA issued a circular in August highlighting a number of key principles to provide further guidance to Registered Institutions (RIs) regarding the product risk rating of high-yield bonds, high-yield bond funds and related products. The HKMA expects RIs to adopt robust methodologies and a prudent approach in assessing product risk and assigning risk ratings to such products.

During the year, the HKMA collaborated with the OCI, the SFC and the Hong Kong Federation of Insurers to introduce measures to enhance disclosure relating to the sale of investment-linked assurance scheme (ILAS) products. Under the new requirements, AIs and other insurance intermediaries selling ILAS products were required, by the end of June 2013, to implement an Important Facts Statement (IFS) requesting customers to set out their reasons and considerations for procuring such products. Starting from the same date, the HKMA also required AIs to make written pre-sale disclosure of monetary and non-monetary benefits receivable by the AI or any of its associates from the insurance company for distributing the ILAS product. This is in line with the requirement currently applicable to the sale of other investment products by AIs and aims to help customers make meaningful comparisons when deciding whether to invest in ILAS or other investment products. Another measure arising from the HKMA's collaboration with the SFC and the OCI was the enhanced disclosure requirements in the ILAS Product Key Facts Statement, introduced by the SFC in May.

In April, the HKMA issued a circular to the banking industry describing some common issues on customer suitability assessment and product disclosure that were identified in its supervision of AIs' sale of ILAS products. It also published an *inSight* article drawing attention to how potential ILAS customers could benefit from the IFS. In addition, the HKMA and other relevant financial regulators provided advice to the Investor Education Centre (IEC) on educational materials published during the year to help the public better understand ILAS and the new regulatory measures.

To encourage healthy development of the private wealth management industry in Hong Kong, the HKMA worked with the industry to establish the Private Wealth Management Association (PWMA). One of the key objectives of the PWMA is to promote proper conduct, integrity and professional competence among private wealth management practitioners. The HKMA has worked closely with the PWMA, 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 (ECF) for private wealth management practitioners. The ECF covers competence benchmarks and continuing professional development for private wealth management practitioners. Industry consultation on the proposed framework was completed in December, with the industry generally supportive of the proposed framework.

The HKMA instituted a mystery shopping programme in 2013 to assess AIs' compliance with regulatory requirements in selling investment and insurance products. A service provider was engaged to undertake the programme, and the field work has been completed. The HKMA will identify any industry-wide issues for sharing with the industry.

During the year, specialist teams conducted 24 on-site examinations covering the sale of investment products by private banks, product due diligence, selling processes and training regarding investment products, compliance with new or enhanced regulatory requirements, the sale of ILAS products and non-linked long-term insurance products, and the sale of MPF-related products. The HKMA also launched a new half-yearly survey on the sale of investment products to private banking customers, to be submitted by all RIs starting from 2014. The survey will show industry trends in these sales and facilitate the HKMA's off-site surveillance of such activities.

The HKMA processed five applications to become RIs and four applications from RIs to engage in additional regulated activities. It also granted consent to 230 executive officers, who are responsible for supervising the securities activities of RIs, and conducted background checks on 8,193 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

The formulation of the future regulatory framework governing the distribution of insurance products, under the proposed independent Insurance Authority, continued during the year with the HKMA working closely with both the OCI and the Financial Services and the Treasury Bureau (FSTB).

Following the commencement of the statutory regime regulating MPF intermediaries on 1 November 2012 and the Employee Choice Arrangement, the HKMA carried out on-site examinations and off-site surveillance to assess AIs' compliance with the performance requirements under the regime.

Supervision of treasury activities

To assess AIs' compliance with the standards and guidance set out in the recently updated modules on "Sound Systems and Controls for Liquidity Risk Management" and "Stress-testing" in the Supervisory Policy Manual (SPM), the HKMA conducted 41 thematic on-site examinations at selected AIs in addition to on-site examinations of AIs' treasury and derivatives activities focusing on their control framework for managing market and counterparty credit risk.

The HKMA devoted considerable resources to monitoring and analysing financial market events with potentially significant or systemic implications for the banking industry and provided technical expertise on material or emerging risks in relation to AIs' treasury and derivatives operations.

Supervisor-driven stress testing programme

The HKMA initiated a bottom-up stress testing programme in late 2012 to better understand the resilience of locally incorporated retail banks under extreme adverse economic conditions, and to encourage them to develop plans to address potential problems in case economic conditions come under stress. The HKMA has analysed the stress test results prepared by the participating AIs and discussed with them how their stress testing processes could be further improved.

Credit risk management and asset quality

Credit growth and asset quality

The banking sector's total lending increased by 16%, compared with 9.6% in 2012 (Table 2). As loan growth outpaced that of customer deposits, the overall loan-to-deposit ratio increased to 70.4% at the end of 2013 from 67.1% a year ago. The overall asset quality of the banking sector remained sound with the classified loan ratio standing at 0.54% at the end of the year.

Table 2 **Growth in loans and advances**

% change	**2013**	2012
Total loans and advances	**16.0**	9.6
Of which:		
– for use in Hong Kong	**10.6**	7.0
– trade finance	**43.8**	9.1
– for use outside Hong Kong	**21.5**	15.9

Stable Funding Requirement

In view of the low interest rate environment and the rising loan-to-deposit ratio, the HKMA continued to monitor AIs' lending practices to ensure their credit underwriting standards remained prudent. While the overall liquidity of Hong Kong's banking system remained stable in 2013, there were rising concerns that liquidity conditions might deteriorate when the US started to taper its quantitative easing policy. The HKMA introduced a Stable Funding Requirement in October 2013 to ensure AIs could maintain stable business operations continuously when market liquidity came under stress. Banks with higher rates of loan growth are required to arrange sufficient stable funds as liquidity support.

Prudential supervision of mortgage loans

There were renewed signs in early 2013 of the property market heating up as quantitative easing measures of the major central banks intensified. The HKMA introduced on 22 February further countercyclical macroprudential measures to:

(1) increase the mortgage rate upward adjustment used for stress-testing property mortgage loan applicants' debt-servicing ability from at least two percentage points to at least three percentage points;

(2) lower the applicable loan-to-value (LTV) ratio limits for all commercial and industrial property mortgages by 10 percentage points; and

(3) limit the maximum LTV and debt-servicing ratio (DSR) for stand-alone car park space mortgage loans to the levels applicable to commercial and industrial property mortgage loans, and limit the maximum loan tenor to 15 years.

To ensure that AIs maintain a higher level of regulatory capital as a cushion against risks arising from their residential mortgage lending activities, the HKMA also introduced a 15% risk-weight floor for all new residential mortgage loans (RMLs) granted after 22 February 2013 by AIs that have been approved to adopt the IRB approach for calculating the credit-risk capital charge.

The six rounds of macroprudential measures introduced since October 2009 have strengthened the resilience of AIs to the potential impact of a property market downturn. The average LTV ratio for new RMLs declined to 54% in December 2013 from 64% in September 2009 before the first round of these measures was introduced. The average DSR for new RMLs decreased to 35% in December 2013 from 41% in August 2010 when the tighter DSR requirement was introduced.

Separately, it was noticed that some money lenders were engaging in mortgage lending. Since most money lenders are not regulated by the HKMA, they are not required to follow the HKMA's prudential measures. As these mortgage lending activities may undermine the effectiveness of HKMA's prudential measures, the HKMA has requested AIs to review their policy for providing loans to money lenders to ensure the effectiveness of the HKMA's measures.

So far, property mortgage loans extended by these money lenders were very limited, estimated to be around 1% of total RMLs of the banking sector. Nevertheless, as the mortgage underwriting standards of money lenders can be rather relaxed, the HKMA will closely monitor the activities of these money lenders and their potential impact on bank's mortgage business.

European sovereign debt crisis and US tapering

While policies introduced by international organisations and European authorities have reduced the risk of a European sovereign debt crisis, risks to economic growth in the European Union remain. The HKMA is monitoring developments to ensure foreign AIs, particularly those from Europe, have sound funding and liquidity positions. It has also communicated with the home supervisors of some European AIs to discuss matters of supervisory interest through teleconferences, bilateral meetings, supervisory colleges and crisis management groups.

On 18 December, the US Federal Reserve announced it will, starting from January 2014, reduce the amount of debt securities purchased each month from US$85 billion to US$75 billion. The pace of further reductions in asset purchases, and when these purchases will cease and interest rates will normalise, remain uncertain. In the near term, market volatility is likely to continue as financial markets react to changes in US economic conditions and adjust expectations about further adjustments to the asset purchase programme. The HKMA has taken steps to contain the potential adverse impact of unprecedented monetary easing policies and required AIs to be prudent in managing their liquidity and interest rate risks to cater for possible fund outflows.

Mainland-related business

Renminbi banking business

In view of the improving liquidity in the offshore renminbi foreign exchange and money markets and the sound and sustained development of renminbi business in Hong Kong, the HKMA took additional steps to provide greater flexibility for AIs in managing and developing this business. In April, the HKMA removed the renminbi Net Open Position Limit and the 25% renminbi minimum liquidity ratio. The conditions prescribed in February 2012 regarding the application of renminbi liquefiable assets for the calculation of the statutory liquidity ratio were also lifted. With these relaxations, the regulatory requirements for AIs' management of foreign exchange and liquidity risks in renminbi business are in line with those applicable to other currencies.

Tapping the Mainland market

Thirteen locally incorporated banks have established business operations on the Mainland, of which eight operate through subsidiary banks incorporated on the Mainland. These banks continued to expand their branch networks during the year, maintaining over 440 Mainland branches or sub-branches, either directly or through subsidiaries. The HKMA conducted on-site examinations of these subsidiary banks and their major branches in Mainland China.

The industry's aggregate on-balance-sheet non-bank exposures to the Mainland amounted to the equivalent of HK$3,161.3 billion at the end of 2013, or 17.3 % of total assets. These included exposures of HK$773.4 billion booked at Mainland subsidiaries of Hong Kong banks. Compared with 2012, the aggregate on-balance sheet exposures grew by 30.6%.

With the increasing Mainland-related business conducted by AIs, the HKMA stepped up surveillance of these activities and introduced a new Quarterly Return of Mainland Activities, requiring all AIs to report more granular information on their non-bank Mainland exposures, with the first report to cover their position at the end of September 2013.

Following a noticeable increase in Mainland-related trade financing activities, the HKMA, in June, requested the internal audit functions of AIs active in this business to conduct thematic review to verify the adequacy and effectiveness of their risk management and internal controls for such activities. Where deficiencies were identified, the HKMA required AIs to take remedial action within a reasonable timeframe for less serious problems or, where more significant issues were found, to commission an independent external party with relevant expertise to conduct a more in-depth review of the trade financing activities.

Prevention of money laundering and terrorist financing

To ensure AIs' systems and controls are effective and comply with the legal and regulatory requirements, the HKMA progressively strengthened the resources of its AML specialist teams and conducted 19 on-site examinations in 2013.

Earlier in the year, the HKMA conducted seminars for the Chief Executives and other senior management of AIs to reiterate the importance of senior oversight and a strong risk culture to AML/CFT. Annual AML/CFT seminars were also held to provide training for a wider audience of industry practitioners.

The HKMA issued a guidance paper on transaction screening, monitoring and suspicious transaction reporting that was developed in collaboration with the industry and the Joint Financial Intelligence Unit. A circular was issued in June reminding AIs of the importance of effective controls against tax evasion.

The HKMA continued to participate in various international and regional forums for AML/CFT, including the Financial Action Task Force, the Asia/Pacific Group on Money Laundering and the AML/CFT Expert Group established by the Basel Committee.

Co-operation with overseas supervisors

The HKMA participated in college-of-supervisors meetings organised by the home supervisors of 19 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, operation and other types of risk management and supervisory issues relating to megabanks.

Bilateral meetings were held with banking supervisory authorities from Australia, Canada, France, Germany, Indonesia, Japan, Macau, the Mainland, Malaysia, the Netherlands, Singapore, South Korea, Switzerland, Taiwan, the UK and the US to ensure effective co-operation and co-ordination. There were also regular exchanges with authorities outside Hong Kong on institution-specific issues and developments in financial markets.

The HKMA also participated in the crisis management groups of nine 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 contributed its views on the cross-border resolution framework as well as the co-operation protocol between home authorities and non-Crisis Management Group host authorities in the Cross-Border Crisis Management Working Group. The HKMA also organised jointly with the SFC and the Swiss Financial Market Supervisory Authority a two-day Recovery and Resolution Planning Workshop for the host regulators of two Swiss AIs from the Asia-Pacific region.

Basel III

Implementation of Basel III in Hong Kong

The HKMA implemented the first phase of the Basel Committee on Banking Supervision's Basel III capital standards and their associated disclosure requirements, with the Banking (Capital) (Amendment) Rules 2012 (BCAR 2012) and the Banking (Disclosure) (Amendment) Rules 2013 (BDAR 2013) coming into effect respectively on 1 January and 30 June 2013, in accordance with the Basel Committee's transition timetable.

Capital standards

Pillar 1

The first phase of the capital standards introduced in the BCAR 2012 enhanced the level and quality of AIs' regulatory capital base by introducing three revised risk-weighted minimum capital ratios (Common Equity Tier 1 capital ratio, Tier 1 capital ratio and Total capital ratio) computed using a more stringent definition of capital, and by broadening the coverage of the ratios for AIs' counterparty credit risk (CCR) exposures.

The capital positions of locally incorporated AIs remained strong under the new capital standards, with their Total capital ratios averaging well above the international minimum of 8% and the core part of their capital base being made up of common equity (about 80% of Total capital or 96% of Tier 1 capital)[2], the highest (in the sense of most loss-absorbing) form of regulatory capital under Basel III.

Further refinements were introduced into the Banking (Capital) Rules, through the Banking (Capital) (Amendment) Rules 2013, which took effect from 30 June 2013, to reflect further technical guidance issued by the Basel Committee in the form of frequently asked questions (FAQs) in late 2012. The HKMA also developed and issued in September 2013 a set of local FAQs to aid interpretation and facilitate understanding of the Basel Committee's technical guidance in the context of the local Banking (Capital) Rules.

In December, the HKMA issued a circular to all locally incorporated AIs regarding the retention, by AIs adopting the IRB approach for calculating their regulatory capital for credit risk, of capital floors beyond the first three years of IRB implementation. This reflects an earlier decision of the Basel Committee to keep the capital floors in place pending further discussion on any future permanent capital floors or benchmarks.

Pillar 2

To accommodate the implementation of Basel III in Hong Kong, the HKMA made certain changes to its "Supervisory Review Process" (SRP, the local Pillar 2 framework) and put the revisions into effect on 1 January 2013 following industry consultation. The changes to the SRP are principally designed to address any potential overlap between Pillar 2 capital requirements and the Basel III capital buffers when the latter come into effect in 2016. The basic concept underpinning the HKMA's SRP remains, however, that Pillar 2 capital is, and will continue to be, a constituent part of an AI's minimum regulatory capital requirements.

[2] Capital position of AIs at the end of December 2013.

Basel III (continued)

Pillar 3

The disclosure requirements introduced in the BDAR 2013 are designed to enhance the consistency and comparability of capital disclosures among banks and across jurisdictions. To facilitate their implementation, the HKMA issued a set of standard disclosure templates in August 2013, prescribing the format for AIs' disclosures in relation to their capital base under the BDAR 2013. AIs with an interim financial period ending on 30 June 2013 are already subject to the amended rules for their Pillar 3 disclosures for that period.

Capital buffers

The second phase of implementation of the Basel III capital standards focuses on introducing the capital conservation and countercyclical capital buffers. These two buffers are designed to reinforce banks' resilience beyond the minimum capital requirements. 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 certain distributions. The countercyclical capital buffer is designed to be "switched on" in times of excessive credit growth associated with the build-up of system-wide risks and "switched off" in a credit cycle downturn in order to help maintain the flow of credit to the real economy. The countercyclical buffer works by extending the range of the capital conservation buffer. Basel III provides for "jurisdictional reciprocity" with regard to the operation of the countercyclical buffer, meaning that individual bank regulators will require banks incorporated in their jurisdictions to calculate their countercyclical buffer requirements taking into account the countercyclical buffer rates applicable not only in their home jurisdictions but also in the other jurisdictions where they have private sector credit exposures. The buffers will be phased in between 2016 and 2018 in line with the transition timeline of the Basel Committee. Preparatory work was undertaken for the introduction of the necessary legislative amendments to the Banking (Capital) Rules and the Banking (Disclosure) Rules in 2014 to implement the two buffers.

National authorities will require frameworks for the surveillance of the build-up of systemic risk for the purposes of the countercyclical buffer. In an industry consultation paper issued in December 2013, the HKMA set out its proposed approach to assessing the build-up of systemic risk and implementing the countercyclical buffer in Hong Kong more generally and sought comments from the banking industry.

Liquidity standards

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 bank's liquidity risk exposure to further strengthen and promote consistency in liquidity risk supervision globally.

In January 2013, the Basel Committee announced a package of revisions to the LCR, including:

(i) introduction of an additional category of "Level 2B assets" that may, at national discretion, be recognised as "high-quality liquid assets" (HQLA) under the LCR;

[3] The LCR is designed to promote banks' short-term liquidity resilience by ensuring that they have sufficient high-quality liquid assets to survive for at least 30 days under acute stress. The NSFR is designed to reduce funding risk over a longer time horizon of up to 1 year by requiring banks to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress.

Basel III (continued)

(ii) re-calibration of the stress assumptions for the outflow rates for retail and corporate deposits, committed credit and liquidity facilities, and repos with central banks;

(iii) affirmation of the usability of banks' HQLA in times of stress; and

(iv) introduction of a phase-in arrangement for the LCR, whereby national authorities may set the minimum LCR requirement at 60% on 1 January 2015, to be increased by 10 percentage points annually to reach 100% on 1 January 2019.

The NSFR was under review by the Basel Committee during 2013, but it remains the Committee's intention that the NSFR, including any revisions, should be implemented starting from 1 January 2018.

Since 2012, the HKMA has undertaken a series of industry consultations on the implementation of the Basel III liquidity standards in Hong Kong. The latest consultation in July 2013, which reflected the Basel Committee's revisions to the LCR and the industry comments from the previous consultations, closed in September. Having considered the comments received, the HKMA refined and communicated its policy proposals to the industry in December. These include:

(i) Adoption of a two-tiered approach to applying the liquidity standards

Larger and more sophisticated AIs will be classified by the HKMA as "Category One" institutions and be subject to the LCR, while other AIs will be classified as "Category Two" institutions and be subject to a modified version of the existing 25% minimum Liquidity Ratio. In determining the classification of foreign bank branches in Hong Kong, the HKMA will additionally consider the interplay between "group factors" affecting these branches (for example, group compliance with the Basel LCR and liquidity risk management standards) and other classification criteria.

(ii) Adoption of the Basel Committee's implementation timetable with the LCR being introduced in phases from 1 January 2015

The modifications to the Liquidity Ratio for Category Two institutions will also come into effect on 1 January 2015. The HKMA will seek to adopt the Basel liquidity risk monitoring tools from 2015 as part of its ongoing liquidity risk supervision.

(iii) Selective recognition of Level 2B assets under the LCR

Among the Level 2B assets defined by the Basel Committee, the HKMA will allow AIs to include as HQLA: non-financial corporate debt securities with a credit rating of A+ to A- and, subject to case-by-case approval, residential mortgage-backed securities (at least rated AA or above) that meet all relevant qualifying criteria. Other Level 2B assets (that is, listed common equities and triple-B rated non-financial corporate debt securities) will not be recognised given their higher price volatility and market liquidity risks.

(iv) Adoption of Alternative Liquidity Approaches allowed under the Basel framework

To address the limited supply of HQLA denominated in Hong Kong dollars, Category One institutions will be allowed to use foreign currency HQLA to cover Hong Kong dollar liquidity needs, subject to the application of usage limits

Basel III (continued)

and haircuts on such foreign currency HQLA as required by the Basel Committee.

(v) *Treatment of cash-flow items under the LCR*
The HKMA will generally follow the Basel requirements and, for those items where the local treatment is subject to national discretion, the HKMA intends to apply a 10% outflow rate for "less stable retail deposits"; a 5% outflow rate for "retail term deposits"; and a 3% outflow rate for "trade finance contingent funding obligations". These proposed treatments take account of local circumstances and the approaches adopted in other major jurisdictions.

(vi) *Major modifications to the existing Liquidity Ratio*
Net interbank placements (that is, net of interbank borrowings) maturing within one month will continue to be recognised as "liquefiable assets" under the modified ratio, subject to some restrictions to address residual liquidity risks. "Eligible loan repayments", on the other hand, will cease to be recognised as "liquefiable assets", but the liquidity value of such inflows will be allowed to offset "qualifying liabilities" in the denominator of the ratio.

The finalised liquidity proposals will form the basis for a set of Banking (Liquidity) Rules to be tabled in the Legislative Council (LegCo) in 2014 for implementation from 1 January 2015.

Leverage Ratio

An important area of regulatory reform introduced under Basel III is the establishment of a simple, non-risk-based leverage ratio, which is intended to serve as a complementary measure to the risk-based capital framework and to guard against the build-up of excessive leverage by banks. Under the Basel Committee's transition timetable, regulators are required to monitor banks' leverage ratios by reference to a 3% "testing minimum" in a "parallel run" period during 2013 to 2017. Any final adjustments to the definition and calibration of the leverage ratio will be carried out in 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

The HKMA consulted the banking industry on a reporting template for parallel run purposes in 2013 and will amend the template in response to a set of changes made by the Basel Committee to the final leverage ratio framework in January 2014.

SIFI framework

The Basel Committee and the FSB continued to work on the policy framework designed to address the systemic risks and moral hazard associated with systemically important financial institutions (SIFIs). Taking into account the lessons learnt from applying its assessment methodology to identify global systemically important banks (G-SIBs) in the past couple of years, the Basel Committee published an updated version of the G-SIB framework in July, to replace the original

Basel III (continued)

November 2011 publication. The latest version of the G-SIB framework includes disclosure requirements for banks above a certain size to enable the framework to operate on the basis of publicly available information.

The FSB has continued to publish annually a list of the G-SIBs identified under the Basel Committee's methodology. The latest list issued in November identified the "buckets" into which the G-SIBs fall for the purpose of assessing the additional higher loss absorbency capital requirements to be applicable to them. In addition, to ensure the transparency of the methodology, the "denominators" used to calculate the banks' scores, (that is, the aggregates of each of the 12 G-SIB indicators across the sample of banks), as well as the cut-off score and thresholds used to allocate the banks to their respective buckets were also published by the Basel Committee.

Supplementary guidance for Basel III implementation

The HKMA released in September a revised policy paper on the Recognition of External Credit Assessment Institutions (ECAIs) for the purposes of regulatory capital calculation under the Banking (Capital) Rules. The revisions, made after consultation with the banking industry and the ECAIs concerned, reflect the principle underlying Basel III that supervisory authorities should refer to the Code of Conduct Fundamentals for Credit Rating Agencies issued by the International Organization of Securities Commissions (IOSCO) when determining ECAI eligibility for regulatory capital calculation. The enhanced ECAI recognition criteria set out in the revised policy paper should ensure the external credit assessments used by AIs for regulatory capital calculations result from a rigorous rating process conducted by an ECAI, which is independent both organisationally and financially, and which provides adequate transparency in relation to its rating methodologies and the performance of its ratings. ECAIs currently recognised by the HKMA for regulatory capital purposes were requested to submit self-assessment reports on their compliance with the revised recognition criteria to the HKMA in November.

In addition, the HKMA issued in December an updated guideline on "Financial Instrument Fair Value Practices". It incorporates amendments relating to the full recognition, for regulatory capital purposes, of fair-value gains arising from fair-valued financial instruments as a component of "Common Equity Tier 1 capital" under Basel III. This contrasts with the position under Basel II where such gains were generally required to be excluded from Core Capital and included as Supplementary Capital with a 55% haircut. AIs are expected to ensure that all of their fair-value estimates are reliable and determined in accordance with applicable accounting standards and the supervisory guidance set out in the guideline.

Supervisory reporting

In April 2013, the HKMA issued a revised regulatory return for use by AIs in reporting their capital positions on the basis of the new capital requirements introduced by the BCAR 2012. AIs started reporting their capital positions as at the end of March 2013 using the revised return. Further updates to the completion instructions for the regulatory return were made in June to align with the technical changes introduced by the BCAR 2013.

Basel III (continued)

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 and Disclosure and its Quantitative Impact Study Working Group, which have been tasked with addressing outstanding issues relevant to the application of the Basel III standards.

Basel III implementation monitoring process

Since 2011, the HKMA has been contributing data from selected Hong Kong-incorporated AIs for the Basel Committee's quantitative impact study (QIS) to facilitate assessment of the impact of the Basel III capital and liquidity requirements[4] and the monitoring of banks' progress in implementation.

The HKMA also carried out a similar QIS locally on liquidity covering a broader sample of AIs. Based on the results to date, AIs in Hong Kong are generally not expected to encounter major difficulties in complying with the new liquidity standards over the transition period, although some may need to adjust their liquidity profile or liquid asset composition. The information collected in the QIS 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) and inform the HKMA's policy decisions on implementing the liquidity standards in Hong Kong.

[4] In the case of capital requirements, the impact is assessed based on a fully implemented basis, for example, including capital buffers and higher loss absorbency capital surcharge for systemically important financial institutions.

Improving Supervisory Policy Framework

Interim reporting requirements for over-the-counter (OTC) derivatives transactions

In line with the commitment of the G20 leaders to reform the OTC derivatives market globally, the HKMA has been working with the SFC and the FSTB to establish a regulatory regime for the local OTC derivatives market through amendments to the Securities and Futures Ordinance (SFO) to implement, among other things, mandatory reporting and clearing requirements.

In early 2013, the FSB indicated an expectation that member jurisdictions (including Hong Kong) should have trade reporting regulations in place by July 2013. As the new regulations under the SFO are not expected to take effect before mid-2014 and to meet the FSB's expectation, the HKMA issued a circular in June (following industry consultation) under section 63(2) of the Banking Ordinance, requiring all licensed banks (being the major players in the local OTC derivatives market) to report specified OTC derivatives transactions to the local trade repository operated by the HKMA until such time as the relevant legislation under the SFO comes into effect. The interim reporting arrangements, which represent a simplified version of the full-scope reporting to be implemented under the SFO, took effect from 5 August with a grace period of around six months for banks to achieve full compliance.

Other policy development work

Financial Sector Assessment Programme (FSAP)

The HKMA conducted a detailed self-assessment of its regulatory and supervisory framework against the Basel Committee's *Core Principles for Effective Banking Supervision* for the purpose of an update by the IMF of the FSAP assessment for Hong Kong (the last FSAP was undertaken in 2003). In addition to conducting the self-assessment, the HKMA held extensive meetings with the FSAP assessors to explain the legal and regulatory framework for banking supervision and how it is carried out. It also arranged for the assessors to meet government officials and the private sector (including banks, credit rating agencies and audit firms) to enable them to undertake a comprehensive review of the financial sector in Hong Kong. In collaboration with selected AIs, the HKMA and the FSAP assessors conducted a number of liquidity and solvency stress tests during the review, using scenarios and frameworks either adopted by the HKMA or proposed by the FSAP assessors. Overall, the preliminary assessment results were favourable. The HKMA will follow up on recommendations from the assessors and, where appropriate, amend relevant rules and supervisory guidance to close any regulatory gaps.

Accounting standards

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have continued their work to improve and converge accounting standards. The development of high-quality, converged accounting standards for the classification and measurement of financial instruments and for loan-loss provisioning is of particular relevance to banks and banking supervisors. While progress has been made towards eliminating differences in the Boards' respective classification and measurement models, the two standard-setters have developed different expected-loss models for public consultation. In essence, the difference between their proposals is in the impairment accounting for performing loans. Given the importance of a single, globally applied, standard on accounting for loan-loss provisions that recognises credit losses earlier and more consistently, the banking regulatory community has been closely following developments in this area. In particular, following its Plenary meeting in November, the FSB publicly urged the IASB and the FASB to make further efforts towards convergence.

During the year, the HKMA maintained regular dialogue with the Banking Regulatory Liaison Group of the Hong Kong Institute of Certified Public Accountants (HKICPA) on topics of common interest. These included the latest 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 initiatives domestically and internationally, including those in relation to banks' external auditors.

Recovery and resolution

As part of its package of policy measures to reduce the risk posed by systemically important financial institutions, the FSB issued a set of *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes) in November 2011. All member jurisdictions of the FSB, including Hong Kong, 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, including financial market infrastructures.

The extent to which the existing arrangements for contingency planning and dealing with distressed firms meet the new standards in the Key Attributes has been assessed by the Hong Kong authorities and subsequently by the FSB in a thematic peer review. This work confirmed that although the statutory and regulatory framework in Hong Kong was relatively well-developed before the global financial crisis, some significant gaps exist in comparison to the requirements of the Key Attributes and these need to be addressed to reflect the latest best practices for effective resolution regimes. The HKMA worked with the FSTB, the SFC and the OCI during the year on a public consultation on proposals for legislative reform to address the identified gaps. The consultation was launched in January 2014.

The new standards in the Key Attributes also require the implementation of local recovery and resolution planning requirements for banks in Hong Kong. Following consultations with the industry, the HKMA developed a new SPM module on Recovery Planning, which is expected to be finalised in early 2014. The HKMA also participated in the crisis management groups for a number of G-SIBs where work is underway to develop firm-specific group-level recovery and resolution plans.

International co-operation

The HKMA continues to take part in a range of international and regional forums for banking supervisors. It is currently a member of 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 and the Supervision and Implementation Group. The HKMA is also a member of the sub-groups under the Policy Development Group, including the Capital Planning Group, the Large Exposures Group (which consulted during 2013 on a new international framework for measuring and controlling large exposures), the Quantitative Impact Study Working Group, the Task Force on Standardised Approaches (a new group established in 2013 to undertake a review of the Standardised Approach to the measurement of credit risk within the Basel framework and consider enhancements to ensure it remains robust and appropriately calibrated), the Task Force on Interest Rate Risk in the Banking Book (another new group established in 2013 to consider options for capturing interest rate risk in the banking book within the capital framework), the Working Group on Disclosure, the Working Group on Capital, and the Working Group on Liquidity. 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 Co-operation and on Assessment of Vulnerabilities. It also participates in a number of the FSB working groups including the Resolution Steering Group, the Cross-border Crisis Management Working Group, the Intensity and Effectiveness Group, the Compensation Monitoring Contact Group, and the Workstream on Other Shadow Banking Entities.

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. As part of its work within the EMEAP Working Group on Banking Supervision, the HKMA is the Champion of the Interest Group on Liquidity (IGL). During the year, the IGL carried out two surveys on EMEAP jurisdictions' intended policies for implementing the Basel III liquidity standards, with the results discussed at the Working Group's meetings.

FSB Peer review of Germany

In the context of the FSB's peer review programme, the HKMA led the international expert team that assessed the steps taken, or planned, by the German authorities to address recommendations from the IMF's FSAP and Reports on Observance of Standards and Codes relating to financial regulation and supervision, as well as to institutional and market infrastructure, that are deemed most important and relevant to the FSB's core mandate of promoting financial stability. Once approved by the FSB, the final report is expected to be published in April 2014.

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 2012, all AIs reported full, or almost full, compliance[5]. The non-compliance issues reported mostly concerned transparency and disclosure of information and the related policies and procedures. The AIs concerned have taken active steps to address the issues. The HKMA also conducted thematic examinations of three 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, conducted a review of the Code to further enhance practices. The Committee discussed and agreed on amendments to strengthen the disclosure and transparency of banking services and promote good banking practices, offering better protection to financial consumers. The amendments are expected to be introduced in 2014.

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*. The effective approaches for three of the 10 Principles, which were identified as higher-priority principles, were endorsed at the G20 Summit in September.

[5] With seven or fewer instances of non-compliance.

Treat Customers Fairly Charter

The Treat Customers Fairly Charter, a joint initiative of the HKMA and the banking industry, aims to foster a stronger culture of fair treatment of customers at all levels within banks and at all stages of their relationship with customers. The Charter, comprising five high-level principles, draws on good practices locally and overseas and the *G20 High-level Principles on Financial Consumer Protection*. At a launching ceremony hosted by the HKMA on 28 October, all 22 retail banks in Hong Kong signed up to the Charter.

Chief Executive of the HKMA, Mr Norman Chan, gives his opening remarks at the Treat Customers Fairly Charter launching ceremony. Twenty-two retail banks in Hong Kong have signed up to the Charter, pledging to provide better and stronger protection to bank customers in Hong Kong.

To promote the Charter's principles, the HKMA has also discussed with the banks the possibility of abolishing dormant account fees and waiving low-balance fees for vulnerable groups and the provision of basic banking services. In response, all retail banks which previously charged dormant account fees have abolished such fees. All banks that charge low-balance fees waive the fee for vulnerable customers. They will also adopt a flexible approach in relation to the charging of low-balance fees for low-income customers, either treating them as vulnerable customers and waiving the low-balance fee, or providing them with unlimited or limited free access to branch counter services in relation to their use of basic bank accounts which do not have a minimum balance requirement.

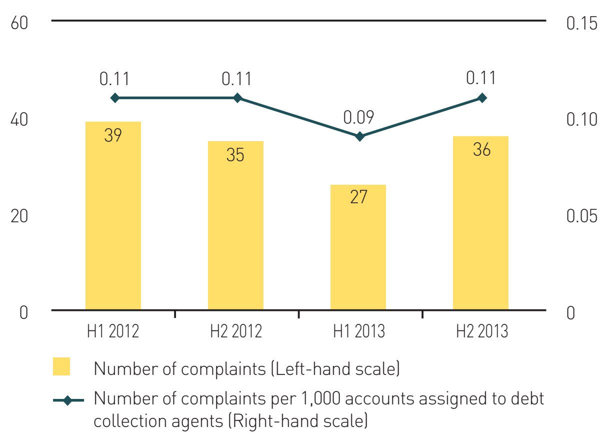
Credit data sharing

At the end of 2013, 118 AIs and subsidiaries of AIs were sharing commercial credit data through the Commercial Credit Reference Agency (CCRA). The scheme contained the credit data of more than 129,000 business enterprises, about 18% of which were sole proprietorships and partnerships. On the sharing of consumer credit data, the HKMA conducted two on-site examinations to review AIs' compliance with the regulatory requirements on the positive mortgage data sharing scheme and related policies and controls. Some issues and areas for improvement were identified. The AIs concerned have been asked to take appropriate actions to address those issues.

Customer complaints relating to debt collection agents employed by AIs

The number of complaints received by AIs about their debt collection agents decreased to 63 from 74 in 2012 (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**



Banking Stability

Consumer education

The HKMA launched a consumer education programme encouraging the public to be "smart and responsible" in the use of banking services. The programme started with radio broadcasts with smart tips on using ATMs and internet banking through computers and smartphones, and on spending with credit cards. Feature articles and illustrations also appeared in the print media to disseminate such tips. The HKMA worked with the IEC to organise a creative competition to educate young adults on money management and financial planning. Seminars for senior secondary school students were also held at community halls to promote responsible spending. A designated webpage with the icon "Consumer Education Programme" was developed on the HKMA website to facilitate public access to programme materials.

Enforcement

Banking complaints

The HKMA resolved the bulk of the backlog of complaints which had built up in recent years because of the earlier need to give priority to resolving Lehman Brothers-related cases. By the end of the year, the total number of outstanding cases had been reduced from 1,313 to 500 (Table 3). Handling of new complaints on banking services was expedited, with most being resolved within three months of being received.

The number of complaints received regarding mis-selling of investment products declined by about half (to 59) for the year. However, the number of complaints relating to insurance products increased by 39 cases (to a total of 93), ILAS by 12 cases (to 44) and credit card fees and charges by 37 (to 62). These areas will be a focus of attention in 2014.

Feature articles and illustrations in the print media

Table 3 **Banking complaints received by the HKMA**

	2013			2012
	Conduct - related issues	General banking services	Total	Total
In progress on 1 January[Note]	675	638	**1,313**	1,927
Received during the year	237	878	**1,115**	916
Completed during the year	(620)	(1,308)	**(1,928)**	(1,530)
In progress on 31 December	292	208	**500**	1,313

Note: The related figures have been adjusted after reclassification of certain complaints.

Enforcement actions

In June, the HKMA suspended the registration of a current relevant individual (RelI) for three years under the Banking Ordinance, following an investigation which found that the RelI was not a fit and proper person in relation to the sale of an ILAS product to a customer in October 2010. In July, the HKMA and the SFC reached an agreement with The Royal Bank of Scotland N.V. (RBS), formerly known as ABN AMRO Bank N.V., pursuant to section 201 of the SFO with respect to the sale of Lehman Brothers-related equity-linked notes. Under the agreement, RBS agreed to make a repurchase offer to eligible retail investors in the equity-linked notes. In December, the offer was extended to eligible professional investors by a further agreement between the HKMA, the SFC and RBS.

During the year, disciplinary sanctions, ranging from suspension to a life ban, were imposed by the SFC on eight former RelIs following referral by the HKMA.

Banking complaints-handling and enforcement processes review

The HKMA commissioned an external consultant to undertake an independent review of its complaints-handling and enforcement processes with the aim of making them more effective. The review was completed in January 2014 and made a number of recommendations relating to the framework, structure and people, processes and controls, reporting and documentation. The recommendations are being considered by the HKMA.

Deposit Protection Scheme

The Deposit Protection Scheme (DPS) continued to offer protection to deposits up to $500,000 per depositor per bank. Based on the results of a self-assessment conducted in 2012 against the *Core Principles for Effective Deposit Insurance Systems* jointly issued by the Basel Committee and the International Association of Deposit Insurers, a more focused review was conducted to study and evaluate ways to make the DPS more efficient and effective, including improvements to its infrastructure and capacity, as well as mechanisms to handle a payout in the event of a bank failure.

Following the self-assessment, a two-year payout reform plan was developed to improve payout efficiency. Amendments were made to the Information System Guideline to improve the availability and quality of information to be provided by DPS member banks (Scheme members) to facilitate prompt compensation payments to depositors in 2013. An early warning system was also established between the HKMA and the Hong Kong Deposit Protection Board to facilitate timely notification to the deposit insurer of a possible bank failure when specified indicators are met. The advance notification will allow early preparation to speed up any eventual payout.

In 2013, the FSAP led by the IMF completed a review of the crisis management and bank resolution framework in Hong Kong, including the functioning of the DPS in contributing to financial stability in Hong Kong.

To monitor compliance with the DPS Representation Rules by Scheme members, the system of annual self-assessments by Scheme members and on-site examinations by the HKMA was maintained. The results were satisfactory and no significant issues of non-compliance were identified.

Emphasis continued to be placed on the coverage and effectiveness of DPS publicity and community education activities. The publicity campaigns undertaken during 2013 sustained the general awareness of the DPS at 77%. Given this high level of general awareness, more effort was devoted to community education and outreach programmes aimed at specific groups, such as senior citizens, housewives and young people.

Oversight of financial market infrastructures

During the year, the HKMA issued a policy statement setting out its approach to oversight of the financial market infrastructures (FMIs) under its purview. The policy objectives of the HKMA in overseeing these FMIs are to promote their general safety and efficiency, to limit systemic risk and to foster transparency. The aim is to make the FMIs more resilient to financial crises and to protect the monetary and financial systems in Hong Kong from possible destabilising effects arising from disruption to the FMIs.

The Clearing and Settlement Systems Ordinance (CSSO), which was enacted in 2004, 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 (CMU), Hong Kong dollar Clearing House Automated Transfer System (HKD CHATS), US dollar CHATS, Euro CHATS, Renminbi CHATS and the Continuous Linked Settlement (CLS) System. The reporting service of the OTC Derivatives Trade Repository of the HKMA (HKTR) was launched in July 2013. The HKTR is owned and operated by the HKMA. Since it is not a clearing or settlement system, it is not a designated system under the CSSO. The HKMA published a new oversight framework and commenced oversight of the HKTR in July 2013. However, it is the policy intention of the HKMA to oversee the HKTR in the same way and apply, where relevant, the same standards, as the other FMIs under its purview.

The Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the Technical Committee of the IOSCO published the *Principles for Financial Market Infrastructures* (PFMI) in 2012. The PFMI constitutes the latest international standards on the oversight of the FMIs including systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories. In Hong Kong, the HKMA and SFC jointly issued a policy statement in March on the adoption of the PFMI for the systematically important FMIs in Hong Kong. To implement the requirements under the PFMI, the HKMA issued, also in March, an amended statutory guideline, "Guideline on the Oversight Framework for Designated Systems" under the CSSO, and published a new guideline in July on the oversight of the HKTR, the "Guideline on the Oversight Framework for the Hong Kong Trade Repository".

Except for the CLS System, the HKMA oversees other FMIs under its oversight through off-site reviews, continuous monitoring, on-site examinations and meetings with management. All the FMIs continued to comply with the relevant requirements.

During the year, the HKMA worked extensively with FMIs under its purview to ensure observance of the PFMI, including requesting them to conduct self-assessments, which it then reviewed. The HKMA considers the FMIs generally observe the relevant PFMI principles, although further work is required in specific areas where the principles strengthen risk management requirements and broaden the scope of applicability.

International participation

The HKMA continues to participate in the meetings and forums on FMI oversight matters. It is a member of the CPSS and attended meetings of the main committee and its working groups on topics relevant to FMI oversight. The HKMA also participated in a task force established by the CPSS and the IOSCO responsible for monitoring and assessing the implementation of the PFMI by different jurisdictions. The Level 1 assessment, which reviewed whether jurisdictions had completed the process of adopting legislation and policies implementing the PFMI, revealed the HKMA had adopted the PFMI within its oversight framework.

The HKMA is 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 FMIs in Hong Kong use, and rely on, its services and may be exposed to risks in the event of any disruption to its operations. The HKMA attended meetings held by the Forum and during the year, it also participated in a task force, established under the Forum, on the development of the assessment methodology for Annex F of the PFMI, which applies to critical service providers.

The HKMA also participates in the international co-operative oversight of the CLS System through the CLS Oversight Committee. The CLS System is a global clearing and settlement system operated by the CLS Bank for cross-border foreign exchange transactions. It enables foreign exchange transactions involving the CLS eligible currencies, including the Hong Kong dollar, to be settled on a payment-versus-payment (PvP) basis. During the year, the HKMA attended various meetings and teleconferences of the CLS Oversight Committee to discuss matters concerning the operations and developments of the CLS System, as well as Hong Kong dollar-specific matters to ensure the System continued to meet the safety and efficiency requirements under the CSSO.

In addition to the CLS System, the HKMA also discussed with relevant overseas authorities to further strengthen the co-operative oversight of links established between the FMIs in Hong Kong and those overseas. 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, whose members are appointed by the Chief Executive of the Hong Kong Special Administrative Region, 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 assesses whether the HKMA has applied the same procedures to all designated systems. The Committee met twice in 2013 and reviewed four regular reports and 22 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

The HKMA encourages the retail payment industry to adopt a self-regulatory approach by issuing codes of practice to promote the safety and efficiency of retail payment systems.

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 2013, 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 2013, 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 2013, Hong Kong had 156 licensed banks, 21 restricted licence banks, 24 deposit-taking companies and 15 approved money brokers. During the year, the HKMA granted two bank licences to two foreign banks and approved one money broker incorporated outside Hong Kong. One licensed bank revoked its authorization during the year.

The HKMA issued a circular on skills and knowledge development for directors of locally incorporated AIs in August 2013. The circular informed AIs of the broad results of a survey in 2012 on the training and development activities made available to directors and observations from meetings with candidates for director, chief executive and alternate chief executive appointments since August 2012. The circular also set out the approach the HKMA will take to enhance the knowledge and skills of directors, chief executives and alternate chief executives and announced the formation of an advisory group, led by the HKMA, with members drawn from the HKIB and persons with strong experience in the industry to advise on skills and knowledge development for directors.

The HKMA sees advantages in the provision of programmes to the industry to support skills and knowledge development for directors of AIs. In 2013, the HKMA worked with the HKIB to develop induction and continuing programmes for directors. In September and October, the HKIB organised a two-module Corporate Governance programme, aimed at the introductory level for recently appointed directors of AIs. The programme had solid response with over 100 participants attending at least one of the modules.

Supervision of parent companies of banks

In October 2013, the HKMA elaborated its policy on applications to hold more than 50% of the share capital of AIs incorporated in Hong Kong from persons who are neither banks nor supervised financial institutions. In considering such applications, the HKMA's primary concern will be to ensure that any risks that may be posed to the existing or proposed AI by the applicant, and any other members of the corporate group of which the applicant is a member, are understood and well contained. To achieve this, the HKMA may impose conditions on the applicant, who will generally be asked to establish a holding company incorporated in Hong Kong, whose sole purpose will be to hold the existing or proposed locally incorporated AI (it may conduct other business or activities if they are for the purposes of providing support to the business or activities of the existing or proposed AI). This immediate holding company will itself be subject to certain conditions, in addition to those imposed on the applicant and its ultimate holding company (if applicable). The conditions to be imposed will cover, among other things, requirements on capital adequacy, liquidity, large exposures, intra-group exposures and charge over assets, group structure, activities undertaken, risk management, fitness and propriety of directors and senior management and the submission of financial and other information to the Monetary Authority.

PLANS FOR 2014 AND BEYOND

Supervisory focus

Risk governance

Recognising the importance of a strong risk culture within AIs to the safety and soundness of the banking sector, the HKMA will focus on the risk governance of AIs and continue its efforts to strengthen communication with the risk management functions, as well as the boards or board-level committees of locally incorporated retail banks.

Credit growth

In the light of uncertain global economic conditions and heightened concerns about market volatility, the HKMA will continue to take proactive steps to ensure Hong Kong's banking system is resilient to a possible reversal of the credit cycle, and that the banking sector can perform a stable and sustainable credit intermediation function.

Mainland-related business

AIs' Mainland-related business will remain an important supervisory focus. The HKMA will continue with its established supervisory approach with a heightened emphasis on prudence underpinned by proactive and forward-looking supervision. The HKMA will conduct on-site examinations and off-site analyses of corporate-sector lending, focusing on non-bank Mainland exposures and potential Mainland-related risks.

Supervision of liquidity risk

The HKMA will continue to enhance AIs' liquidity planning and management in anticipation of fund outflows. In line with this, more in-depth liquidity stress tests will be conducted to ascertain the impact of fund flows on the banking system in Hong Kong. The HKMA will continue to closely monitor the interest rate trend and its impact on the banking sector.

Prevention of money laundering and terrorist financing

A new division will be established within the Banking Supervision Department to further strengthen and consolidate the resources available for AML/CFT supervision, allowing an increased number of on-site examinations and desktop reviews and a more proactive approach in mitigating emerging money-laundering and terrorist-financing risks. The HKMA will continue to work with the FSTB, other financial regulators and the industry to keep Hong Kong's AML/CFT regime under review and will develop further guidance on relevant controls.

Active participation by the HKMA in various international AML forums (such as the Financial Action Task Force) will continue in order to ensure Hong Kong's risk-based approach to AML supervision is consistent with international practice and allows more effective use of resources to address areas of higher risk.

Supervision of operational and technology risks

The HKMA's operational and technology specialist teams will be integrated to make supervising AIs' operational and technology risks more effective. To allow early detection of emerging operational risks, the HKMA will increase its supervisory resources and step up monitoring of potential operational events arising from market changes and other external factors. Apart from ongoing supervisory activities such as on-site examinations, off-site reviews and independent compliance assessments, the HKMA will conduct more thematic and business-focused reviews to ensure AIs have adequate systems and controls to manage operational risks. Separately, the HKMA is working with the e-Banking Security Committee of the Hong Kong Association of Banks (HKAB) to update the SPM on the "Supervision of E-banking" with a view to taking into account the latest technology and market developments.

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 provide advice and assistance to the private wealth management industry, the HKIB, HKSI and TMA in finalising and launching the ECF

- share with the industry and other regulators industry-wide issues and good practices identified in the mystery shopping programme to enhance AIs' compliance culture, sales practices and internal controls

- continue to work with the OCI and the banking industry on enhancing AIs' practices in selling insurance products

- continue to co-operate with the FSTB and the OCI in the legislative process for a statutory regime for establishing an independent Insurance Authority

- continue off-site and on-site surveillance of AIs' conduct in selling securities, MPF and other investment and insurance products, including strengthened risk-based supervision of the sale of investment products to private banking customers with the newly launched half-yearly survey.

Supervision of treasury activities

The HKMA will continue to conduct on-site examinations of AIs' treasury and derivative activities, follow up with selected AIs on weaknesses identified through thematic examinations on liquidity risk management, and expand compliance checks to more AIs based on risk-materiality assessments. Supervisory resources will be deployed to areas of concern, such as assessment of AIs' treasury position booking practices.

Supervisor-driven stress testing programme

The HKMA will further develop and enhance the supervisor-driven stress testing programme as one of the tools for supervising the capital management of AIs. The improvements will bring the programme more into line with international standards and latest developments through, among other things, making AIs' stress testing more robust and consistent, and scrutinising and validating AIs' submissions through a combination of on-site examinations and off-site reviews of their assumptions, methodologies and results. The HKMA will ensure a closer link between AIs' stress test results and their capital requirements.

Co-operation with overseas supervisors

A key item on the HKMA's supervisory agenda will be to work with the crisis management groups of international banks on formulating recovery and resolution plans in accordance with the timetable set by the FSB. Efforts will be made by the HKMA to ensure the timely sharing of bank-specific prudential and other matters, including the latest developments on liquidity and solvency positions with overseas supervisors. With the creation of the Single Supervisory Mechanism in Europe later in 2014, the HKMA looks forward to developing a close working relationship with the new European supervisory body.

Basel III

Capital standards

Under the Basel Committee's transition timetable, regulations for the implementation of the second phase of the Basel III capital standards (the capital conservation buffer, the countercyclical capital buffer and, for banks identified as G-SIBs or D-SIBs, the higher loss absorbency requirements) are required to be in place from 1 January 2015. This will allow banks one year to adjust their capital planning to meet the new requirements as they are phased in from the beginning of 2016. The HKMA expects to consult the industry during 2014 on the proposed amendments to the Banking (Capital) Rules to implement the new standards, with the aim of tabling the amendments before the LegCo for negative vetting in the fourth quarter, and the proposed guidance (in the form of SPM modules) to establish the framework for, and set out key aspects of, the operation of the new standards.

Where necessary, the HKMA will develop and issue further supplementary guidance to facilitate consistent interpretation and application of the Banking (Capital) Rules.

Disclosure standards

Under the Basel Committee's transition timetable, banks will be required to make disclosures in relation to the Basel III leverage ratio from 1 January 2015. The HKMA will introduce amendments to the Banking (Disclosure) Rules during 2014 to give effect to these disclosure requirements. Other amendments proposed to be introduced at the same time include those corresponding to the second phase of the Basel III capital standards (that is, disclosures in relation to the holding by AIs of regulatory capital for the purpose of meeting the capital buffers and, for those AIs designated as G-SIBs or D-SIBs, the higher loss absorbency capital requirements applicable to them). The introduction of amendments relating to the disclosure of the Basel III LCR standard and the modified Liquidity Ratio will follow, having regard to the LCR disclosure requirements and implementation timetable to be finalised by the Basel Committee in 2014. Where necessary, the HKMA will issue standard disclosure templates in line with the Basel Committee requirements to facilitate consistency and comparability of disclosures among banks and across jurisdictions.

Supplementary guidance for Basel III implementation

An updated SPM module on "Overview of Capital Adequacy Regime for Locally Incorporated Authorized Institutions", reflecting the legislative changes for Basel III implementation, is expected to be issued for industry consultation in 2014. The HKMA will also consider the necessary updates to its existing SPM module on "Guideline on the application of the Banking (Disclosure) Rules" to cover the additional disclosure requirements brought about so far by Basel III implementation.

Basel Committee Regulatory Consistency Assessment Programme

To facilitate and encourage full and consistent implementation of the Basel capital framework, the Basel Committee adopted a Regulatory Consistency Assessment Programme (RCAP) in 2012 to assess the consistency of its member jurisdictions' regulatory capital frameworks with the Basel II, Basel 2.5 and

Basel III (continued)

Basel III standards. The Basel Committee has so far published the results of its RCAP assessments of the US, the European Union, Singapore, Switzerland, Japan, the Mainland, Brazil and Australia. The RCAP assessment on Hong Kong is scheduled to commence in 2014. The HKMA will complete a detailed self-assessment of the prevailing law and rules in Hong Kong against the Basel standards and will work with the RCAP assessment team to facilitate its review and to follow up on any issues that the team may identify.

Liquidity standards

The HKMA will develop a set of Banking (Liquidity) Rules (BLR) to prescribe the liquidity requirements applicable to AIs subject to the LCR and to those that are to observe the modified Liquidity Ratio. The intention is to table the BLR in the LegCo later in 2014 after completing the requisite statutory consultation.

The HKMA will augment the existing liquidity reporting framework to support the reporting by AIs of information in relation to their LCR or modified Liquidity Ratio, and in relation to the Basel liquidity monitoring metrics, where appropriate, to enhance supervision of their liquidity risk profiles and positions. The industry will be consulted on the revised liquidity returns during 2014. The HKMA will also seek to expand the scope and frequency of the local implementation monitoring process, by covering (in addition to the LCR) the reporting of the modified Liquidity Ratio and increasing the reporting frequency from semi-annual to quarterly (and ultimately to monthly) in the second half of 2014. This will give AIs more opportunity to test their reporting systems for the new liquidity reporting framework.

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

The implementation of the new liquidity standards and accompanying reporting framework will necessitate consequential changes to the existing statutory guideline "Liquidity Risk Management" in the SPM. The approach to supervising AIs' management of their liquidity risk will also be updated under the enhanced liquidity regime.

In addition, the HKMA will make appropriate changes to the existing supervisory guideline "Supervisory Review Process" in the SPM to ensure that the assessment of liquidity risk under the Supervisory Review Process accords with the revised liquidity standards and risk management requirements.

SIFI framework

The higher loss absorbency capital requirements for institutions designated as G-SIBs and D-SIBs are scheduled to be phased in from 2016. The HKMA began consulting the industry in March 2014 on policy proposals for a framework to identify D-SIBs in Hong Kong and assess the required level of higher loss absorbency to be applied to them. The framework has been developed by reference to the principles drawn up by the Basel Committee in its "framework for dealing with domestic systemically important banks". In addition to a mechanism for identifying them in Hong Kong and applying higher loss absorbency requirements to them, the local D-SIB framework is also proposed to cover more intensive supervision of, and recovery and resolution planning for, D-SIBs. The HKMA expects to finalise the framework in 2014 with the aim of designating local D-SIBs no later than 1 January 2015 to allow the higher loss absorbency capital requirements to be phased in from 1 January 2016.

While no locally incorporated AIs are currently designated as G-SIBs, the HKMA intends to make provision in the Banking (Capital) Rules empowering the Monetary Authority to designate locally incorporated AIs as G-SIBs, to cover the eventuality of a local banking group meeting the criteria in future. The HKMA also plans to issue guidance to support the implementation of the G-SIB framework in Hong Kong.

Recovery and resolution

During 2014, the HKMA will continue to work with the FSTB, the SFC and the OCI to refine the proposals for the establishment of an effective resolution regime for financial institutions in Hong Kong in accordance with the Key Attributes promulgated by the FSB. An initial three-month public consultation exercise was launched in January 2014 proposing:

- a common framework for resolution, with a single resolution regime under which a designated public authority would be able to intervene to take swift and decisive action to bring about the orderly resolution of a failing financial institution (including financial market infrastructures) within the scope of the regime, in order to secure continuity of critical financial services and protect wider financial stability

- a menu of resolution options as alternatives to insolvency which, where the necessary conditions are met, allow for the compulsory transfer of a failing financial institution, or some or all of its business, to a third party able to continue the provision of critical financial services and the imposition of a "bail-in" of creditors to quickly recapitalise and restore the viability of the failing firm

- robust governance arrangements for the regime as well as safeguards to protect parties who may otherwise be adversely affected by resolution, including safeguards to ensure that no creditor will be worse off than would have been the case in liquidation

- use of the local regime to support group-wide resolutions of cross-border financial services groups being carried out by authorities in their home jurisdictions, where it is assessed that resolution would be consistent with the objectives set for resolution in Hong Kong and would not otherwise disadvantage local creditors.

In relation to local recovery and resolution planning, it is expected that an initial wave of AIs will be required to begin preparing recovery plans in 2014 following the issuance of the new SPM module on Recovery Planning. Work will also begin on a separate complementary SPM module on Resolution Planning. The HKMA will continue to contribute to the group-level recovery and resolution planning being carried out for those G-SIBs with significant operations in Hong Kong.

Development of Supervisory Policies

Credit risk transfer

A supervisory guideline on credit risk transfer is being developed. The guidance will reflect recent international developments in the regulation of securitisation (such as disclosure requirements and measures to align incentives between originators and investors) and the reduction of reliance on the ratings produced by credit rating agencies (such as more stringent requirements for banks' internal credit assessment of securitisation exposures).

Counterparty credit risk management

The supervisory guideline "Counterparty Credit Risk Management" will be updated to bring it into line with the amendments made to the Banking (Capital) Rules for the purposes of Basel III implementation (including, in particular, the introduction of an internal models calculation approach for CCR) under the BCAR 2012, and to reflect other developments in counterparty risk management practices following the global financial crisis.

Monitoring tools for intraday liquidity management

In April 2013, the Basel Committee issued a paper on *Monitoring Tools for Intraday Liquidity Management*, which is designed to complement the qualitative guidance on intraday liquidity management set out in the *Principles for Sound Liquidity Risk Management and Supervision* issued by the Basel Committee in 2008. The HKMA intends to implement the guidance by January 2015, in line with the timetable set by the Basel Committee. The implementation proposals and reporting templates were issued in March 2014 for industry consultation.

Sound systems and controls for liquidity risk management

The HKMA intends to update, in 2014, the statutory guideline "Sound Systems and Controls for Liquidity Risk Management" (LM-2) in the SPM, having regard to the revisions to the LCR made by the Basel Committee in January 2013, international developments on liquidity risk management standards, and the experience gained to date in implementing LM-2. This reflects the HKMA's policy of placing a strong emphasis on the development of prudent risk management systems by AIs to enhance their liquidity resilience and their compliance with LM-2 requirements.

Internal audit and compliance functions

The HKMA will consult the industry on revisions to the supervisory guideline "Internal Audit Function" in the SPM to reflect the latest guidance on "The Internal Audit Function in Banks" issued by the Basel Committee in June 2012. Key areas of revision will relate 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. Consideration will also be given to developing a separate supervisory guideline to provide more detailed guidance on the attributes of an effective compliance function.

Development of Supervisory Policies (continued)

Large exposures and risk concentrations

Once the Basel Committee has finalised the enhanced large exposures regime, which was the subject of consultation in 2013, the HKMA will assess the policy implications for the local large exposures regime. Prior to introducing the new regime in Hong Kong, the HKMA may consider implementing some transitional changes to the reporting of counterparty credit risk exposures arising from foreign exchange, interest rate and other derivatives contracts in the Return of Large Exposures to facilitate more effective monitoring of AIs' large exposures.

Guideline on OTC derivatives market reforms

Once amendments to the SFO come into effect to establish the regulatory regime for the OTC derivatives market, and the relevant rules are issued under the SFO, the HKMA will issue supervisory guidance outlining the key requirements of the regime and its approach to supervising the OTC derivatives activities of AIs.

In September, the Basel Committee and the IOSCO published the final framework for margin requirements for non-centrally cleared derivatives for implementation from December 2015. The HKMA will further update the OTC derivatives regulatory regime in 2014 to implement the new global margining standards in Hong Kong.

External audits of banks

In March, the Basel Committee issued draft revised supervisory guidance on *External audits of banks* for public consultation. Drawing on lessons from the global financial crisis, the proposed guidance aims to improve the quality of external audits of banks by raising the bar to what supervisors expect of banks' external auditors and audit committees. Once the new guidance is finalised, the HKMA will consider the necessary updating of its prudential framework for AIs to reflect the new international standard on bank audit quality.

Other risk management guidance

In 2014, the HKMA will develop, and consult the industry on, new or revised guidance in other areas of risk management, to reflect the lessons of the global financial crisis, or better align with observed international best practices or guidance issued by the Basel Committee, including guidance relating to general risk management controls, market risk management and connected lending.

Accounting and disclosure standards

The HKMA will monitor developments in international accounting convergence, particularly in the area of loan-loss provisioning, and will maintain its 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 active involvement in the work of the Basel Committee and the FSB, including through thematic peer reviews on trade reporting, SIFI supervision, and resolution regimes expected to be undertaken by the FSB in 2014.

Consumer protection

The HKMA will work with the industry's Code of Banking Practice Committee to finalise the revision of the Code with the aim of publishing a revised version within 2014. The HKMA will also 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 monitor how the industry adopts specific measures in 2014 to implement the Treat Customers Fairly principles.

Consumer education

In 2014, the HKMA will broaden the scope of its consumer education programme and launch further initiatives, including video productions, roving exhibitions and outreach activities, to enhance consumers' knowledge of banking services and help them develop a better understanding of their rights and obligations. In addition, the HKMA will continue to collaborate with other stakeholders (for example, the HKAB, the IEC and the Consumer Council) to maximise the benefits of consumer education.

Credit data sharing

The HKMA will continue to review AIs' implementation of the positive mortgage data sharing scheme through conducting on-site examinations of 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 enhance its complaints-handling and enforcement processes taking into account the recommendations made by the consultant. Operational workflows will be revised to enhance productivity and effectiveness of the processes. A more structured programme of specialist training will be provided to staff in the Enforcement Department to enhance their skills and techniques in handling banking complaints.

The HKMA will closely monitor trends relating to complaints received and, where appropriate, take prompt action to contain or mitigate potential adverse consequences.

Deposit protection

The HKMA will continue to assist the Hong Kong Deposit Protection Board (HKDPB) in implementing and operating the DPS. In light of the latest overseas experience of reforms, options for making the handling of payouts more efficient and the DPS more sustainable are being researched and evaluated. A public consultation on the proposals is planned in 2014.

In accordance with the payout reform plan, the payout system, policies and procedures will continue to be revised to support the pre-payout preparatory arrangements and the tightened information submission timeline. To further streamline the payout process, payment channels other than paper cheques for disbursement of compensation will be explored. Self-assessments 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. Publicity efforts will mainly focus on maintaining the general level of awareness of the DPS and informing people who are not easily reached by conventional advertising media about the Scheme.

Oversight of financial market infrastructures

The HKMA will continue to promote the safety and efficiency of the FMIs under its oversight in accordance with the CSSO and the relevant international requirements, and monitor the performance of the operators of retail payment systems under their self-regulatory codes of practice.

The HKMA will work with the FMIs on their observance of the PFMI, including the preparation of the required disclosure framework for individual infrastructures. Assessments of the FMIs will be conducted, and the HKMA will continue participating in the CPSS/IOSCO PFMI implementation-monitoring and assessment exercise. Where appropriate, it will fine-tune its oversight requirements to reflect international practices or in response to developments.

Licensing

The HKMA will continue to work with the industry to encourage the provision of consistent and appropriate training and development programmes for directors of AIs. These activities may be at an introductory or intermediate level targeting both recently appointed and more experienced directors. Topics may range from general issues (focusing on the role and skills of directors, especially independent non-executive directors) to technical issues, covering areas of relevance to the banking sector which would be of particular benefit to directors.

To facilitate assessment of the quality of corporate governance of AIs for the purposes of the Supervisory Review Process, the HKMA, in its August 2013 circular on skills and knowledge development for directors of locally incorporated AIs, requires these AIs to submit a summary record of the training, development and other activities undertaken by each director (including chief executives and alternate chief executives), no later than one month after the end of each calendar year. The first submission is made by AIs at the end of January 2014. The HKMA will analyse these records and assess the extent and effectiveness of the activities provided to, and undertaken by, directors. The findings will help the HKMA identify and determine future initiatives on director development.

International Financial Centre

The global recovery was modest and uneven in 2013, with the advanced economies showing increasing signs of improvement, while emerging market economies generally experienced a slowdown in growth. New policy challenges arose as financial markets responded to the changing pattern of global growth, and capital flows became more volatile amid expectations of a turning point in US monetary policy. Against this background, the HKMA actively participated in international and regional forums to help enhance co-ordination on macroeconomic management and the implementation of global financial regulatory reforms. The increasing use of renminbi in cross-border trade and investment activities further entrenched Hong Kong's role as the global hub for renminbi business. Hong Kong's strong credit standing and robust fiscal performance were recognised by credit rating agency Standard & Poor's, which maintained its top-rated AAA rating for Hong Kong.

OVERVIEW

A divergent trend in growth emerged between the advanced economies and emerging market economies during the year. While the US and Japan saw a pick up in economic activities, many emerging market economies experienced a slowdown in growth. Global financial markets turned more volatile from the second quarter of 2013 as market expectations for the US Federal Reserve's tapering of asset purchases sparked widespread re-pricing of financial assets. For some emerging markets, there were increasing concerns about capital outflows at a time when domestic vulnerabilities and external sector imbalances started to manifest themselves following several years of strong credit growth and sharp asset price rises. In the face of heightened uncertainty, closer international and regional co-operation is needed to promote greater financial stability and to achieve a sustained global economic recovery. International co-ordination is also necessary to ensure consistency and compatibility in the implementation of the various global and national financial regulatory reforms that are being finalised.

The HKMA actively contributes to international discussions on issues of significance to global and regional financial stability. In 2013, it chaired the Monetary and Financial Stability Committee established under the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).[1] The Committee reviews economic and financial developments in the Asia-Pacific region, discusses areas of common interest and, where appropriate, reflects common views. The HKMA also took part in various meetings 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 the implementation of enhancements to the Chiang Mai Initiative Multilateralisation (CMIM).

The development of Hong Kong as the premier offshore renminbi business centre gained further momentum in 2013 with progressive growth in a full range of offshore renminbi activities, including a 46% increase in both renminbi deposits and trade settlement transactions. The scale of clearing and settlement activities and offshore renminbi foreign exchange transactions all reached new heights. Hong Kong's role as a global renminbi hub was also strengthened by efforts to expand renminbi business links and financial flows with the Mainland and overseas markets.

The safe and efficient operation of Hong Kong's financial infrastructure and its continued development play a significant role in reinforcing the competitive edge of Hong Kong as a premier offshore renminbi business centre and an international financial centre. During the year, different components of the financial infrastructure operated smoothly. From January, the operating window of the cross-border renminbi payment service between Hong Kong and the Mainland was extended by six hours to the new cut-off time of 10:30 p.m. This facilitates timely cross-border payments via Hong Kong's renminbi Real Time Gross Settlement (RTGS) system for banks located in time zones behind Hong Kong and the Mainland. The reporting function of the local trade repository for over-the-counter (OTC) derivatives was introduced in time to support the commencement of the interim reporting requirements in August, which brought Hong Kong into line with major overseas markets in terms of the pace of OTC derivatives market reforms.

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 the Mainland, Japan and Korea.

International Financial Centre

REVIEW OF 2013

International and regional co-operation

As global financial markets become more interconnected, the HKMA proactively participated in international and regional forums to exchange views and pursue co-operation on issues of common interest. It participated in discussions under the auspices of the FSB, the Bank for International Settlements (BIS) and the Asia-Pacific Economic Co-operation (APEC) to promote sustainable economic growth and financial system stability. The HKMA also continued to advocate the implementation of global financial regulatory reforms, in particular the recommendations of the Group of Twenty (G20), to help strengthen the resilience of the global financial system.

The HKMA co-organised a Global Risk Forum with the Global Association of Risk Professionals in May to discuss the post-crisis expectation and roles of regulators and financial institutions in identifying, managing, and monitoring institution-level and systemic risks. The meeting was attended by 68 senior officials from regulatory bodies and financial institutions around the world. As a member of the Basel Committee on Banking Supervision (BCBS), the HKMA also hosted the 150th meeting of BCBS in Hong Kong in December. The meeting was attended by senior banking supervisors from 27 jurisdictions to discuss key supervisory issues.

Together with banking supervisors from other jurisdictions, Mr Arthur Yuen (third from left on the front row), Deputy Chief Executive of the HKMA, participates in the 150th meeting of Basel Committee on Banking Supervision.

Representing the Government of the Hong Kong Special Administrative Region, the HKMA participated in the donors' negotiations on the tenth replenishment of the Asian Development Fund, which is a concessional financing facility of the Asian Development Bank for the region's poorest economies. The funding for Hong Kong's contribution to the replenishment was approved by the Finance Committee of the Legislative Council (LegCo) in February 2013.

As part of its efforts to promote co-operation with other central banks in the region, the HKMA held a bilateral meeting with Bank Negara Malaysia in August, with both sides agreeing to strengthen co-operation in promoting financial market development, including offshore renminbi business and the internationalisation of Islamic finance.

Promoting monetary and financial stability in Asia

The HKMA maintained its commitment to regional co-operative initiatives to promote financial stability in Asia and to harness the region's collective voice in international financial affairs. As Chair of the EMEAP Monetary and Financial Stability Committee, the HKMA held regular meetings and ad hoc teleconferences with Committee members to review major economic and financial market developments. The HKMA continued to prepare the Committee's half-yearly Macro-Monitoring Report to assess the region's risks and vulnerabilities and policy implications. A private-sector roundtable was organised during the year for the Committee to exchange views with senior representatives of key financial institutions and relevant multilateral organisations on long-term investment financing in the region against the backdrop of European bank deleveraging. The HKMA led the Committee's discussions on the impact of the global financial regulatory reforms on Asian markets, and facilitated the formulation of a collective regional view on issues of concern to contribute to the international discussions. It also continued its active participation in the ASEAN+3 CMIM-related discussions.

As one of the deputy chairs of the EMEAP Working Group on Payment and Settlement Systems, the HKMA has been working closely with the People's Bank of China (PBoC) and 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.

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 performance and fiscal strength. These efforts contributed to the affirmation of Hong Kong's sovereign credit ratings by all major credit rating agencies in 2013. 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, sizable fiscal reserves, consistently healthy fiscal performance and strong net external asset position. 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

During the year, the HKMA continued to work with the industry to enhance Hong Kong's renminbi financial platform and expand business flows with corporates and financial institutions overseas. It also maintained close collaboration with Mainland authorities on facilitating renminbi fund flows between the onshore and offshore renminbi markets.

At the end of 2013, outstanding renminbi customer deposits and certificates of deposit totalled RMB1,053 billion, an increase of 46% from a year earlier. Renminbi trade settlement transactions handled by banks in Hong Kong also expanded by 46% to RMB3,841 billion. Renminbi financing activities remained buoyant with the issuance of renminbi bonds in Hong Kong amounting to RMB117 billion and the outstanding amount of renminbi bonds growing by 31% to RMB310 billion. Outstanding renminbi bank loans totalled RMB116 billion at the end of 2013, up 46% from 2012. The scope of renminbi investment products also increased further, while the turnover of the offshore renminbi foreign exchange market (including spot and forward transactions) in Hong Kong doubled to some US$15-20 billion equivalent on an average day.

As the global hub for rapidly growing renminbi business and financial activities, the average daily turnover of Hong Kong's renminbi RTGS system exceeded RMB500 billion in December, with around 90% of the transactions conducted in the offshore market. At the end of 2013, 216 banks were participating in Hong Kong's renminbi clearing platform, of which 191 were subsidiaries and branches of overseas banks or the overseas presence of Mainland banks. Banks in Hong Kong handled some 70–80% of the renminbi payments conducted with the Mainland and among the offshore markets globally, according to statistics of the Society for Worldwide Interbank Financial Telecommunication (SWIFT). The amounts due to, and due from, between Hong Kong banks and their overseas counterparts exceeded RMB160 billion in each direction.

To enhance Hong Kong's financial infrastructure and support the development of renminbi lending and financial products, the CNH Hong Kong Interbank Offered Rate fixing (CNH HIBOR fixing) was launched in June by the Treasury Markets Association (TMA). The HKMA also enhanced its renminbi liquidity facility for authorized institutions (AIs) in July, providing overnight renminbi funds on T+0 basis and one-day funds on T+1 basis. These are in addition to the one-week funds that were available when the facility was introduced in 2012.

Collaboration on renminbi business between Hong Kong and other economies was broadened in 2013. Facilitated by the HKMA, the first meetings of the private sector dialogues with Australia and Malaysia were held in April and December respectively, while further progress was made at the third meeting of the Hong Kong-London RMB Forum in September. Through these meetings, banks in Hong Kong are able to explore collaboration with their overseas counterparts on a number of aspects, including raising awareness on the use of renminbi, creating more renminbi interbank flows, and developing renminbi products and services to capture opportunities arising from the opening of more channels for cross-border flows with Mainland China. The HKMA also continued to promote the use of Hong Kong's renminbi platform through conducting roadshows in the Middle East and US and engaging overseas corporates and financial institutions through seminars and small-group meetings.

Deputy Chief Executive of the HKMA, Mr Eddie Yue, delivers the welcome remarks at the Third Meeting of the Hong Kong-London RMB Forum held in Hong Kong.

Further progress was made with Mainland authorities on widening the channels for two-way renminbi flows between the onshore and offshore markets. This included expanding the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme by relaxing the investment restrictions and enabling a broader range of institutions in Hong Kong to participate. The Qualified Domestic Institutional Investor (QDII) scheme was also relaxed to allow cross-border investments in renminbi. In addition, the PBoC streamlined requirements for cross-border renminbi transactions, including providing more flexibility for corporates to move renminbi funds from onshore to their offshore entities through intragroup lending.

CEPA

The Tenth Supplement to the Closer Economic Partnership Arrangement (CEPA) was signed in August. Among other measures, the latest Supplement allows Hong Kong financial institutions, including banks, to establish (i) one joint-venture full licence securities company in each of Shanghai city, Guangdong province and Shenzhen city, with shareholding up to 51% and in each of the pilot areas for financial reforms, with shareholding up to 49%; and (ii) joint-venture fund management companies on the Mainland, with shareholding exceeding 50%.

Training

Training programmes were conducted during the year for 296 officials (1,267 man-days) from the PBoC, the State Administration of Foreign Exchange and the China Banking Regulatory Commission. These courses covered topics such as bank risk management and compliance with regulatory requirements, global and regional financial developments and regulatory reforms, monitoring international capital flows and reserves management, financial market development and supervision, and deposit insurance schemes. The HKMA also assisted as coaches in training programmes organised by Mainland authorities and facilitated exchange programmes and seminars for financial industry practitioners from the Mainland.

Government Bond Programme

In the 2013-14 Budget Speech, the Financial Secretary announced plans to double the size of the Government Bond Programme to $200 billion. On 22 May 2013, the LegCo approved the necessary resolution.

The HKMA continued to co-ordinate the implementation of the programme comprising both institutional and retail bond issuances. For the institutional part, eight bond tenders totalling $20 billion, with tenors ranging from two to 10 years, were completed in 2013. The amount of institutional bonds outstanding at the end of the year was $60 billion.

To improve the liquidity of these bonds, the HKMA devised two liquidity enhancement measures for the institutional bond market – the switch tender and the bond swap facility – to be implemented in early 2014. These measures will enhance the effectiveness of market-making activities and liquidity management for Primary Dealers, and facilitate end-investors to trade more efficiently in the market. The HKMA will continue to maintain close contact with market participants to further refine the institutional programme as required.

For the retail programme, a further issuance of $10 billion inflation-linked retail bond (the third iBond) was announced in the Government's 2013-14 Budget. The issuance was arranged by the HKMA with assistance from relevant service providers. The third iBond was offered to Hong Kong residents in June and attracted over 520,000 applications, with application monies approaching $40 billion. The number of valid applications set another record for the local retail bond market. The $10 billion iBond was issued on 24 June. The amount of retail bonds outstanding at the end of the year was $30 billion.

Development of Islamic finance

The development of the Islamic bond ("sukuk") market in Hong Kong forged ahead in July with the enactment by the LegCo of the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 ("ABS Ordinance"). Amending Hong Kong's tax laws was necessary to provide a comparable tax framework for common types of sukuk, vis-à-vis conventional bonds. Building on the momentum of the passage of the ABS Ordinance, the HKMA has been working with the Government to prepare for the issuance of Government sukuk under the Government Bond Programme, subject to the passage of a bill to amend the Loans Ordinance. This is expected to provide further impetus for other potential sukuk issuers from the public or private sectors to consider issuing sukuk in Hong Kong.

The HKMA also took another important step in promoting the development of Islamic finance in Hong Kong by collaborating with Bank Negara Malaysia to set up a private sector-led Joint Forum on Islamic Finance to strengthen collaboration between market participants in Hong Kong and Malaysia. The first meeting of the Forum was successfully held in Hong Kong in December with the participation of senior representatives of eight commercial banks and three fund management companies. The participants exchanged views on the current trends of Islamic finance and discussed measures to advance the development of Islamic finance in Hong Kong.

In addition, the HKMA organised a series of Islamic finance seminars and workshops in collaboration with key Islamic financial centres, international Islamic organisations and local industry associations to promote market knowledge and awareness of Islamic finance. These were well-received by local industry players.

Promotion of asset management business

In promoting Hong Kong's asset management industry and to reinforce its position as a leading asset management centre, the HKMA further explored ways to improve the international competitiveness of Hong Kong's financial markets and provide a more flexible business environment as well as a more favourable tax and regulatory environment for these businesses. Contacts were maintained with the industry and relevant government agencies to assist in the formulation, review and implementation of policies to develop Hong Kong as a full service asset management hub.

The HKMA visited asset owners, asset managers and service providers 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, Basel, Beijing, Dubai, Geneva, Korea, London, Luxembourg, New York, Queensland, Shanghai, Shenzhen, Singapore, Sydney and Toronto.

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.

The Securities and Futures (Amendment) Bill 2013, which provides for the regulatory framework for the OTC derivatives market, was gazetted in June and introduced into the LegCo in July. The HKMA and the SFC are working on drafting the detailed rules for implementing the new framework.

As an interim measure before the new legislation comes into effect, the HKMA issued details of the interim reporting requirements in June, which, under the Banking Ordinance, require the reporting of specified OTC derivative transactions between licensed banks to the trade repository developed by the HKMA. The interim reporting requirements took effect from 5 August 2013.

The HKMA continued to engage the industry through a number of channels, including the OTC Derivatives Market Working Group under the TMA and its sub-groups, to address specific regulatory and infrastructural issues. The HKMA also participated in international forums, including the OTC Derivatives Working Group under the FSB, the OTC Derivatives Regulators' Forum, the BCBS 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.

A close dialogue is also maintained with overseas regulators, through both bilateral and multilateral channels, to discuss cross-border issues arising from the implementation of the OTC derivatives reforms.

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 2013, the Association had 1,649 Individual Members and 81 Institutional Members from banks, investment houses, insurance companies, money brokers, financial information services providers, exchanges and large corporations. During the year, apart from launching CNH HIBOR fixing as mentioned in the earlier part of this chapter, the TMA accomplished several other important tasks:

- **developed the "Code of Conduct for Reference Banks for HKAB's Interest Settlement Rate" and assumed the role of administrator in HIBOR fixing** – the recommendations made by the TMA to the Hong Kong Association of Banks (HKAB) in relation to enhancing the governance and robustness of the fixing mechanism for HIBOR were endorsed by the HKMA for implementation. In particular, the TMA developed the "Code of Conduct for Reference Banks for HKAB's Interest Settlement Rate", which the HKMA endorsed for issuance as an annex to the relevant module under the Supervisory Policy Manual. The TMA also assumed the important role of administrator of the HIBOR fixing process in September 2013.

- **co-hosted the 2013 Global Meeting of FX Committees with the HKMA** – the meeting, the first of its kind to be held in Hong Kong, was attended by representatives of foreign exchange committees from major global financial centres. It provided an opportunity for Hong Kong to showcase the strengths of its treasury markets to the world.

- **co-organised the Treasury Markets Summit with the HKMA** – the September Summit focused on various facets of Hong Kong's asset management business, including the synergies between Hong Kong and Qianhai, the latest developments in the Renminbi Qualified Foreign Institutional Investors scheme, the mutual recognition of funds between Hong Kong and the Mainland, and the opportunities and challenges in developing Islamic capital markets in Asia.

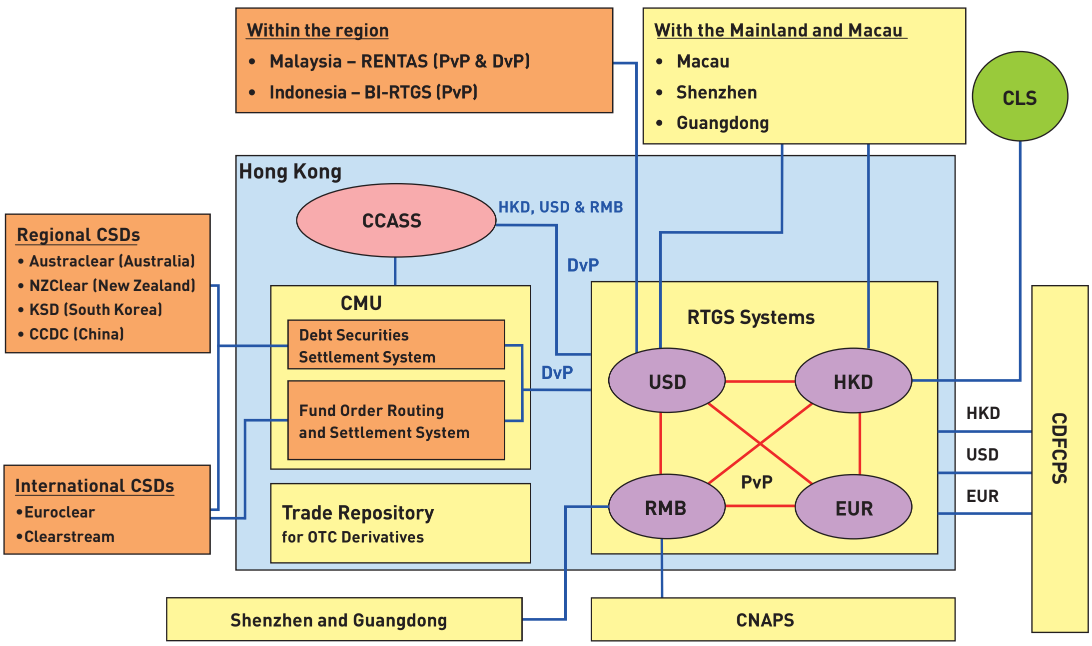
Hong Kong's financial infrastructure

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

Key achievements include the establishment of RTGS systems for the Hong Kong dollar, the US dollar, the euro and the renminbi, and 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 was introduced in 2013.

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 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 – Korea Securities Depository
RENTAS – Real Time Electronic Transfer of Funds and Securities (Malaysia's ringgit RTGS system)

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

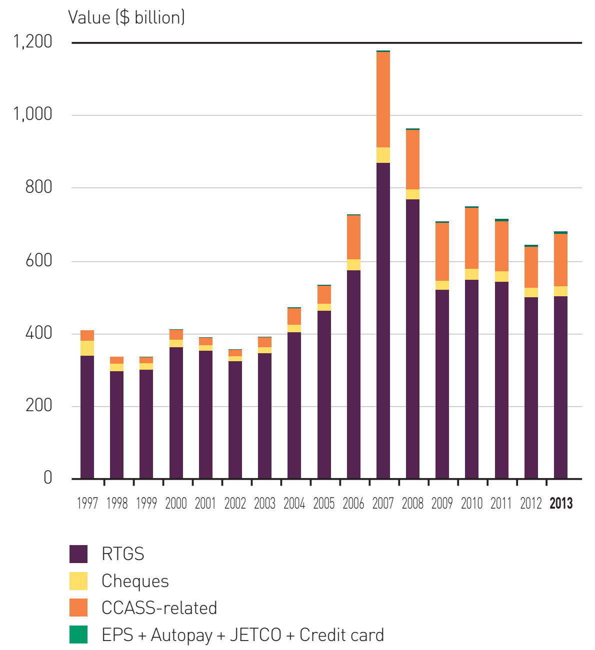
Hong Kong dollar RTGS System

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 delivery-versus-payment (DvP) 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 2013, the HKICL processed a daily average of $507 billion in CHATS transactions (25,034 items), compared with $504 billion (23,054 items) in 2012.

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.

Chart 2 Hong Kong dollar RTGS system average daily turnover



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 2013, rising to a daily average of RMB395 billion in the year of 2013, after increasing from RMB121 billion in 2011 to RMB214 billion in 2012, amid the rapid expansion of renminbi business in Hong Kong. As mentioned earlier in this chapter, the momentum accelerated for the year and the daily average exceeded RMB500 billion in December.

The extension of the operating hours of the renminbi RTGS system since June 2012 has been well received by the banking sector. The average daily value of the transactions processed during the extended window, from 6:30 p.m. to 11:30 p.m., grew significantly from RMB2.6 billion in the second half of 2012 to RMB4.5 billion in 2013, on the back of the development of renminbi business globally and the continuous momentum in the internationalisation of the renminbi.

The average daily turnovers and other details of the foreign currency RTGS systems are listed in Charts 3-5 and Table 1.

Chart 3 US dollar RTGS system average daily turnover

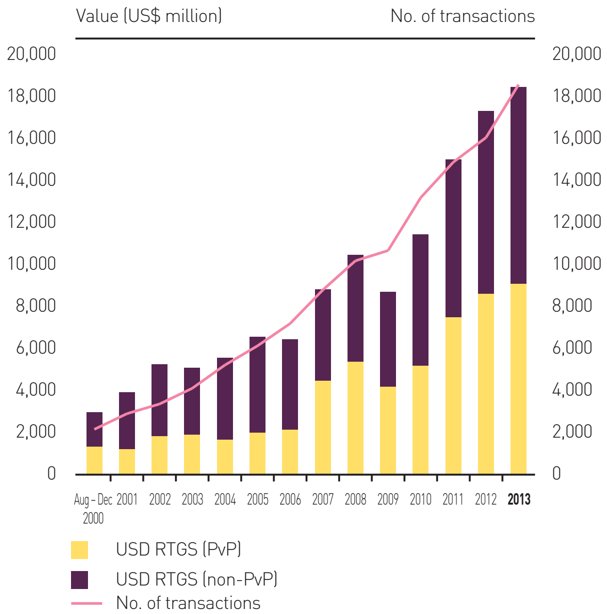


Chart 4 Euro RTGS system average daily turnover

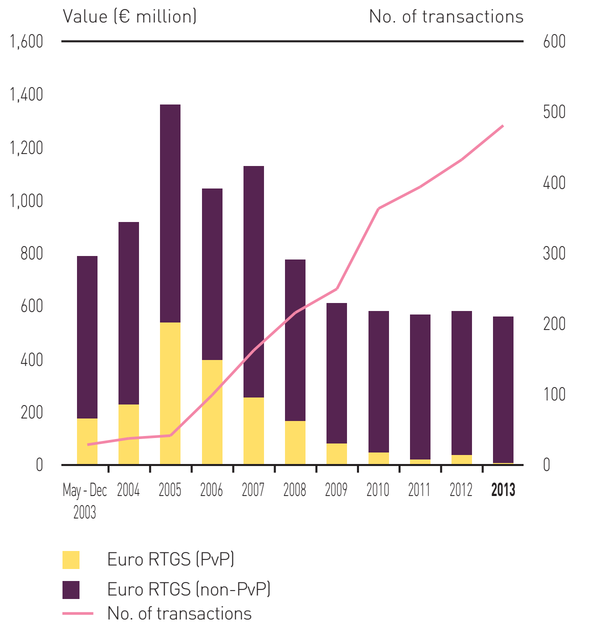


Chart 5 Renminbi RTGS system average daily turnover

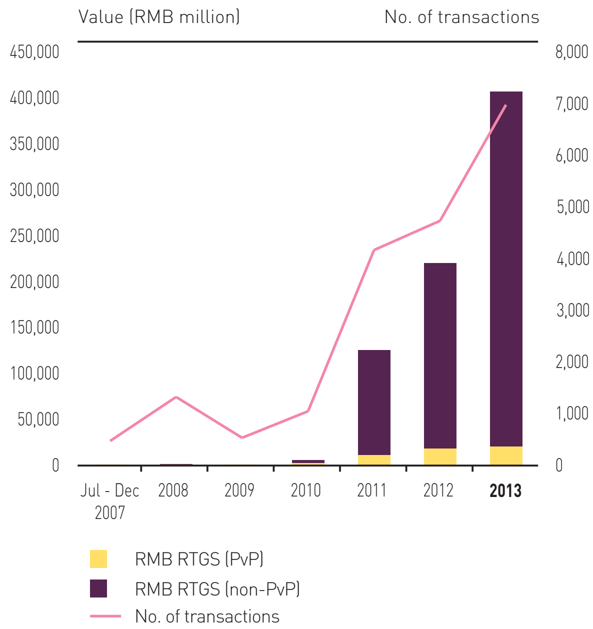


Table 1 Foreign currency RTGS systems

RTGS system	Launch date	Settlement institution or Clearing Bank	Number of participants at the end of 2013	Average daily turnover in 2013	Average daily transactions in 2013
US dollar	August 2000	The Hongkong and Shanghai Banking Corporation Limited	Direct: 94 Indirect: 129	US$18.1 billion	18,220
Euro	April 2003	Standard Chartered Bank (Hong Kong) Limited	Direct: 37 Indirect: 18	€563.7 million	485
Renminbi	June 2007	Bank of China (Hong Kong) Limited	Direct: 184*	RMB395.4 billion	6,788

* 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.

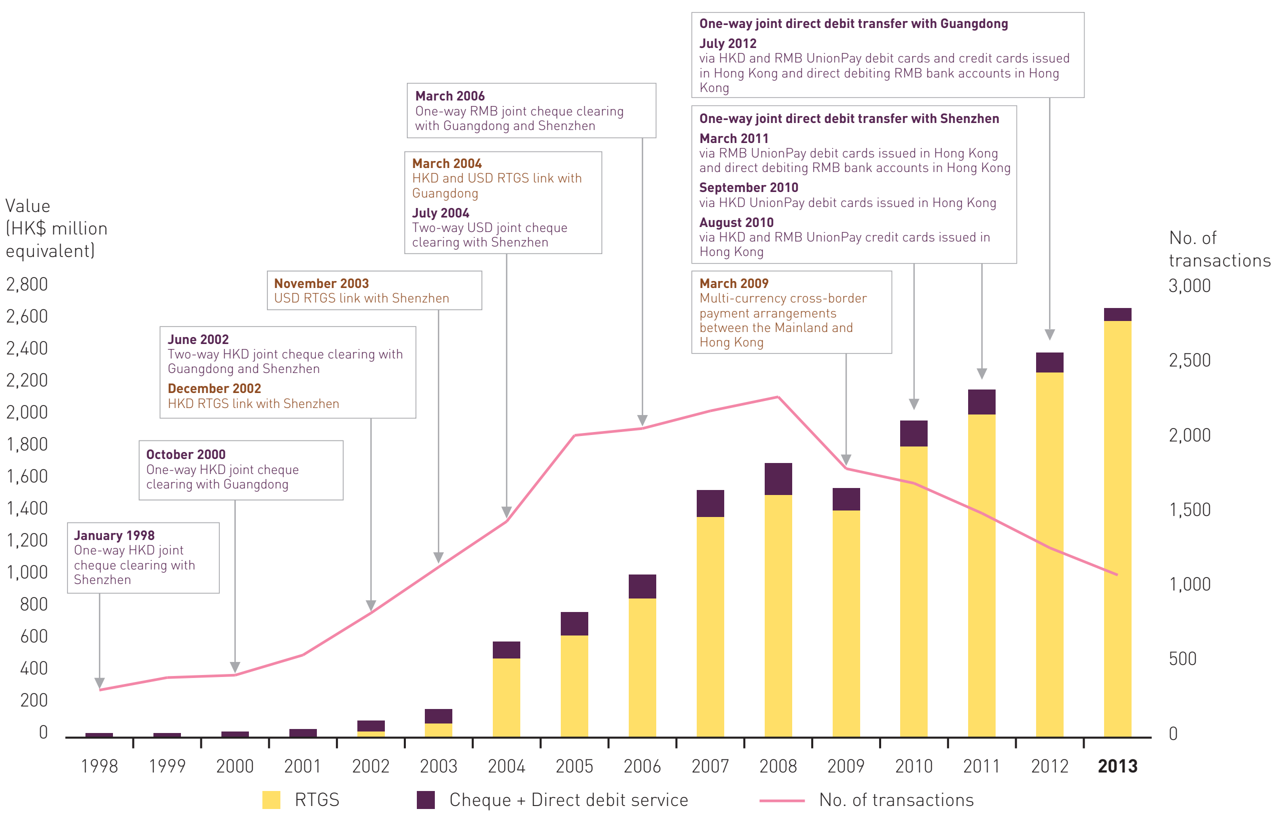
Payment-versus-payment

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 2013, the transaction value of Hong Kong dollar, US dollar, euro and renminbi-related PvP transactions amounted to about HK$4,236 billion, US$2,077 billion, €1 billion and RMB4,356 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. In 2013, the average daily turnover handled by the various system links was equivalent to $2.7 billion, including the RTGS cross-border links with the Mainland's Domestic Foreign Currency Payment Systems launched in March 2009 (Chart 6).

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



The RTGS system links with Shenzhen and Guangdong handled more than 22,000 transactions during the year, with a total value equivalent to $566 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.

The two-way joint cheque-clearing facilities processed about 211,000 Hong Kong dollar and US dollar cheques in 2013, with a value equivalent to $21 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 2013, renminbi cheques with a total value equivalent to around $7 million were cleared.

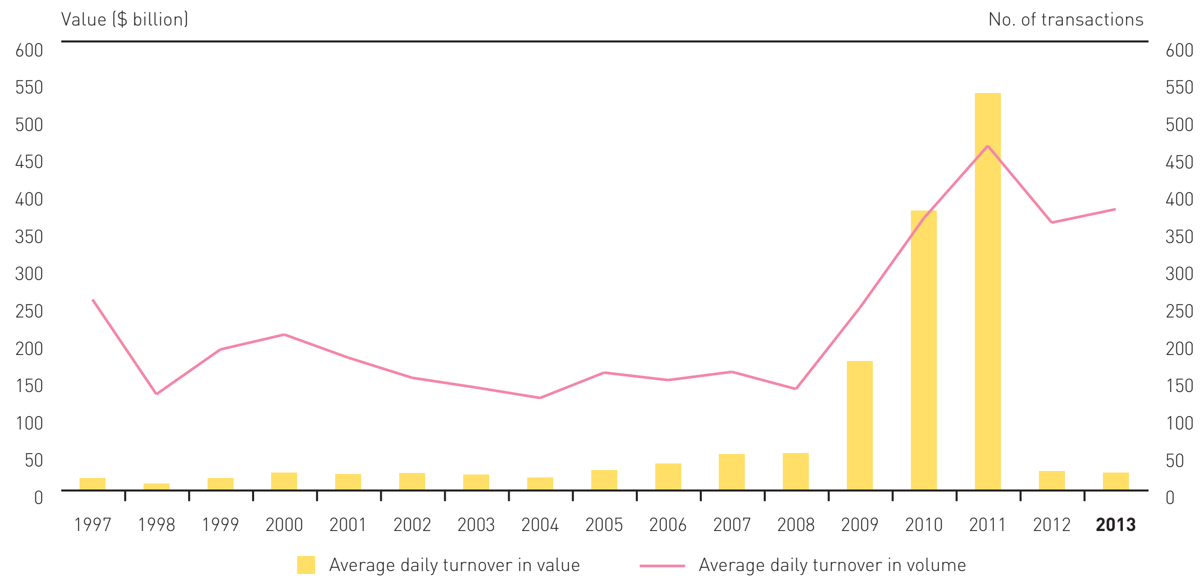
Payment links with Macau

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 2013, Hong Kong dollar cheques with a total value of about $28 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 2013, the CMU processed an average daily value of $24 billion (377 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 $751 billion and the total amount of other debt securities was equivalent to $1,036 billion, of which renminbi debt securities amounted to RMB382 billion.

Chart 7 **CMU secondary market turnover**



Financial infrastructure development

The HKMA completed a number of projects in 2013 to improve the safety and efficiency of Hong Kong's financial infrastructure, and to capture new business opportunities.

Extension of the operating hours of the cross-border renminbi payment service between Hong Kong and the Mainland

The extension of the operating window of Hong Kong's renminbi RTGS system in June 2012 has allowed renminbi payments in the offshore market to be settled until 11:30 p.m. Hong Kong time. However, a payment destined for the Mainland can only be settled on the next working day if it reaches Hong Kong after 4:30 p.m. because the Mainland's nationwide China National Advanced Payment System (CNAPS) for renminbi settlement closes at 5:00 p.m.

To extend access to the onshore market for renminbi settlement via the Hong Kong platform, the renminbi RTGS system in Hong Kong was linked to the Shenzhen Financial Settlement System on 21 January 2013. As the Shenzhen Financial Settlement System operates around the clock, the linkage enabled the extension of the operating hours of the cross-border renminbi payment service between Hong Kong and the Mainland from 4:30 p.m. to 10:30 p.m., thus facilitating, in particular, overseas renminbi payments to reach the Mainland through Hong Kong's renminbi platform on the same day. This will provide a more efficient and comprehensive service to cater for the development of renminbi business in Hong Kong.

Settling UnionPay card payments in renminbi

Supported by the HKMA and the PBoC, UnionPay International began providing merchants in Hong Kong with the option of receiving renminbi for goods and services rendered to Mainlanders using UnionPay debit and credit cards from December. Under the new arrangement, merchants in Hong Kong can choose to receive renminbi or Hong Kong dollars or a combination of both, which will help promote the development of cross-border settlement in renminbi, enlarge the renminbi liquidity pool in Hong Kong and consolidate Hong Kong's role as the premier renminbi business centre.

Pan-Asian CSD Alliance project – cross-border collateral management service

Following the launch of the cross border collateral management service in 2012, the HKMA continued to work with Euroclear Bank to implement a DvP link between Euroclear Bank's global tripartite repo system and the Hong Kong RTGS systems in July. The DvP link enables simultaneous settlement of the cash leg and the collateral leg of a repo transaction, through the domestic RTGS systems and the global tripartite repo system respectively. The funds settled in the domestic RTGS systems are ready for immediate use, significantly improving the settlement efficiency of repo transactions.

Extension of CMU's real time settlement window

The HKMA launched a series of enhancements to the CMU in 2013, one of which involves re-opening the real time settlement window on completion of the daily batch settlement run. This extended the length of the CMU's real time settlement window to 6:30 p.m., thereby enabling and encouraging CMU participants to adopt real time settlement for securities transfers more readily for better risk management purposes.

CMU Central Bank Placement Co-ordinating Window

The HKMA's tendering platform service continued to support the issuance of offshore renminbi sovereign bonds in Hong Kong. Following a smooth placement in 2012, the Ministry of Finance continued to use the HKMA CMU Central Bank Placement Co-ordinating Window for a RMB3 billion offshore renminbi sovereign bonds placement on 26 June. The placement attracted a total subscription of RMB5.48 billion from overseas central banks and monetary authorities. In addition, RMB10 billion in offshore renminbi sovereign bonds was issued to institutional investors through the bond tendering platform. The arrangements were welcomed by subscribers, addressed the increasing demand for renminbi sovereign bonds, and helped expand the investor base for the renminbi bond market, reinforcing the role of Hong Kong as the global hub for offshore renminbi business.

Money settlement service for investment funds

The CMU Fund Order Routing and Settlement Service was enhanced in June to facilitate the money settlement of investment fund orders. Service users are now able to settle payments related to investment fund orders more efficiently, as well as making use of the service for the routing of investment fund orders.

Trade repository for OTC derivatives

The development of the local trade repository for OTC derivatives progressed on schedule. In July, the transaction reporting function of the trade repository was launched to support the implementation of the interim reporting requirements introduced by the banking regulators. A series of preparations were made to ensure the mandatory reporting requirements could be introduced smoothly. The technical specifications and procedures for reporting were well communicated to potential users in late 2012. After the regulators indicated in early 2013 the impending introduction of the interim reporting requirements, the trade repository began an extensive series of training and simulation tests for potential users to ensure their readiness to report. Reporting commenced smoothly in August in line with the interim requirements. The HKMA continued to make progress on the further development of the trade repository to ensure it could cope with local regulatory requirements and to meet international standards.

Retail payment initiatives

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

Implementation of the electronic bill presentment and payment system

With the concerted efforts of the HKMA, the HKAB and HKICL, the electronic bill presentment and payment (EBPP) system was successfully launched in December. The system provides a one-stop platform for users to receive, manage and schedule payments for electronic bills through their internet banking accounts. The multi-currency and multi-functional platform supports bill payments in Hong Kong dollars, renminbi and US dollars. It can also handle 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 donations and presentment of electronic donation receipts.

A total of 23 banks, including all major retail banks in Hong Kong, have agreed to join the EBPP service, with 18 of them launching the service in December. It was also promoted extensively with electronic brochures and banners posted on the websites of the HKMA, the HKAB and participating banks, to raise public awareness and interest in the EBPP service.

International Financial Centre

Deputy Chief Executive of the HKMA, Mr Peter Pang (second from right), attends the launching ceremony of the Electronic Bill Presentment and Payment (EBPP) service to unveil a convenient one-stop bill payment service for the public.

Development of e-cheques

The HKMA continued its discussions with the industry to finalise the functional design of an e-cheque. As a new payment instrument that will be signed, issued, delivered and presented through electronic means, e-cheques will retain all the basic features and benefits of a paper cheque, but still provide enhanced security features and obviate the need for physical delivery and presentment. They will also reduce the cost and improve the efficiency of cheque processing. To ensure the legal backing of e-cheques, the banking industry conducted a review and ascertained that the design and operating model of e-cheques can continue to be supported by the legal framework of the Bills of Exchange Ordinance.

Near Field Communication[4] (NFC) mobile payment

The HKMA conducted a consultancy study to examine the potential of NFC mobile payments and the need to build an interoperable infrastructure to support such development in Hong Kong. One of the study's recommendations, released in March, was to establish a common set of standards and guidelines to facilitate the development of interoperable NFC mobile payment solutions by the banking industry. As a result, the HKMA and the HKAB established an NFC task force to discuss and finalise the standards and guidelines. In November, the HKAB issued the "Best Practice for NFC Mobile Payment in Hong Kong" to the banking industry following a series of reviews by the task force members and the HKMA. The document sets out the benchmarks for various security requirements, technical standards and operational processes involved in the development of interoperable services.

By the end of 2013, five banks and a non-bank payment service provider had either begun or announced plans to provide NFC mobile payment services to their customers. Four mobile network operators also entered the market to support such payment services.

New regulatory regime for stored value facilities (SVF) and retail payment systems (RPS)

The HKMA continued to work closely with the FSTB and the Department of Justice on proposed legislative amendments to the Clearing and Settlement Systems Ordinance for the implementation of a regulatory regime for stored value facilities and retail payment systems. The proposed legislation seeks to empower the HKMA to implement a licensing regime for SVF and a designation regime for RPS, and to perform the relevant supervisory and enforcement functions to ensure adequate consumer protection and the safety and soundness of the facilities and systems in Hong Kong. A three-month public consultation on the regulatory proposals was conducted jointly by the HKMA and the FSTB between 22 May and 22 August. While the comments gathered were generally supportive of the proposals, policy adjustments were made and incorporated in the legislative amendments where appropriate. At the same time, new computer systems and supervisory policy manuals were being developed to pave the way for the implementation of the new licensing and designation regimes.

[4] 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 2014 AND BEYOND

The HKMA will continue to work closely with other central banks, government agencies and the private sector, both locally and internationally, to implement initiatives that enhance Hong Kong's status as an international financial centre.

International and regional co-operation

The global economic recovery is expected to remain modest and uneven in 2014. As the pace of further reductions in the US Fed's asset purchases remains uncertain and data-dependent, financial market volatility will likely continue. Cross-border capital flows will be sensitive to developments in the global economy, particularly in the US, as well as the evolution of the US monetary policy. It is possible that regional economies, which have seen domestic vulnerabilities built up in prior periods, could experience corrections if capital flows reverse. It is therefore important for economies to continue to further enhance co-operation in market surveillance to strengthen the resilience of the financial system. The implementation of global financial regulatory reforms will also require cross-border co-ordination. The HKMA will contribute to the global effort through its continued participation in various central banking and international financial forums.

Hong Kong's sovereign credit ratings

The HKMA will continue its efforts 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 expanding use of renminbi in trade and investment activities, along with the progressive financial liberalisation taking place on the Mainland, are expected to provide further impetus for the continued development of Hong Kong as the premier offshore renminbi business centre. The HKMA will work closely with the financial industry to enhance Hong Kong's renminbi financial platform to meet new business needs and to expand renminbi business links with overseas markets. It will also maintain close dialogue and co-operation with Mainland authorities to enable more efficient circulation of renminbi funds between the onshore and offshore markets and foster closer financial co-operation between Hong Kong and the Mainland, through CEPA and other initiatives.

Market development

The HKMA will pursue the development of the local debt market, and the implementation of 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.

In promoting Islamic finance in Hong Kong, the HKMA will encourage product development, raise market awareness and knowledge of Islamic finance, and forge closer ties with key Islamic financial centres and international Islamic organisations. It will also 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. This will include reaching out to asset managers in major financial centres to promote Hong Kong as an offshore renminbi centre in addition to being an 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. In 2014, the HKMA and the SFC plan to conduct public consultation on the draft rules under this regime.

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 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 actively involved in strengthening renminbi-related financial infrastructure in Hong Kong to cope with the expanding offshore renminbi business opportunities. It will continue to co-operate closely with Mainland authorities to further enhance Hong Kong's renminbi financial infrastructure.

Third cross-border PvP link

During the year, the Bank of Thailand and the HKMA launched a project to establish a cross-border linkage between the US dollar RTGS system in Hong Kong and BAHTNET, the Thai Baht RTGS system in Thailand. The new linkage, scheduled to begin in July 2014, will facilitate cross-border PvP settlement of US dollar and Thai Baht foreign exchange transactions. The linkage will help eliminate principal risk and increase settlement efficiency of the transactions, and will be the third cross-border PvP linkage in the Asian region. Apart from promoting regional monetary and financial stability, it will provide new business opportunities for Hong Kong banks to offer payment and cash management services to Thai banks, thereby reinforcing the status of Hong Kong as a regional payment hub.

Intraday liquidity monitoring indicators

The BCBS issued in April a paper on *Monitoring Tools for Intraday Liquidity Management*, which requires banks to start reporting indicators on their intraday liquidity positions in payment systems by January 2015. A project is now under way by the HKMA to enhance the RTGS systems to support the implementation of the BCBS intraday liquidity monitoring indicators in Hong Kong by the due date.

Pan-Asian CSD Alliance project

The HKMA will continue to work with global tripartite repo system operators and international central securities depositories to enable local financial institutions, using their securities as collateral, to more easily obtain foreign currency liquidity from international financial institutions. The HKMA is also continuing with the development of the centralised corporate action platform to facilitate the processing of corporate action events of debt securities. The platform is expected to be launched in phases from 2015.

Trade repository for OTC derivatives

The next phase of the trade repository system is targeted for launch in the third quarter of 2014, and will focus on including the remaining most commonly traded products in the local market and products requested to be added by regulators. The development of the trade repository system is expected to be substantially completed by the end of 2015.

Retail payment initiatives

The HKMA will conduct a series of publicity campaigns to promote public interest and awareness in the new EBPP service. Merchants from different sectors are expected to join the service in stages, and major government billing departments such as the Water Supplies Department and Rating and Valuation Department are targeted to join by the end of 2014. The HKMA will continue to oversee the implementation of the e-cheque clearing platform and centralised presentment portal, with the launch date tentatively set for the second half of 2015. In addition, the HKMA will monitor the market development of the NFC mobile payment services and how the Best Practice is helping the industry to introduce new services and products with a high degree of interoperability.

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

The HKMA will work with the FSTB and the Department of Justice on drafting the legislation for the proposed new regulatory regime for SVF and RPS taking into account comments from industry participants and members of the public. The amendment bill is expected to be introduced into the LegCo in the 2014/15 legislative year.

Reserves Management

The Exchange Fund recorded an investment return of 2.7% in 2013. Despite the volatile global financial and investment environment, the Investment Portfolio, which does not include contributions from the Long-Term Growth Portfolio (LTGP), achieved a return of 4.9%.

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 74:26. In terms of target currency mix, 77% of the assets are allocated to the US dollar and the Hong Kong dollar, and the remaining 23% 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 and Mainland bonds and equities, private equity, and overseas investment properties. These assets were housed under the LTGP, but starting from 2013, all emerging market and Mainland bonds and equities were transferred to the Investment Portfolio. The LTGP now holds only private equity and real estate investments. The cap for the net asset value of the LTGP is maintained at one-third of the Accumulated Surplus of the Exchange Fund.

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 75% of the Exchange Fund, which includes the entire Backing Portfolio and part of the Investment Portfolio. This part of the Investment Portfolio includes a set of portfolios invested in major fixed-income markets and various derivative overlay portfolios implementing macro risk management strategies for 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 25% 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 to capture 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 2013

The global investment environment in 2013 continued to be volatile. US Treasury yields surged sharply in response to the US Federal Reserve's first hint in May of a possible scaling down of asset purchases, with the 10-year US Treasury yield once rising more than 100 basis points after staying below 2% for much of the early part of the year. Thereafter, US Treasury yields were mainly driven by concern over the Federal Reserve's hinting at reducing its asset purchase programme. The Federal Reserve eventually announced its reduction of asset purchases starting from January 2014 at the Federal Open Markets Committee meeting in December. The 10-year US Treasury yield continued to rise in the second half of 2013 to close the year at above 3%. Other major government bond yields moved largely in tandem with the Treasury yields, with the exception of the Japanese Government Bond market which was supported by the Bank of Japan's aggressive monetary easing policy.

On equity markets, investor sentiment remained generally favourable throughout the year. Together with support from abundant liquidity and improving economic fundamentals, major stock markets posted impressive gains, with American and European equities reaching consecutive record highs. Emerging market equities, however, lagged behind the performance of the developed markets, due to heightened concerns over potentially strong capital outflows as a result of the US's policy normalisation.

On currency markets, the euro strengthened in the second half of the year as market confidence returned on the back of recovering European economic fundamentals, and a receding concern for the euro-zone sovereign debt crisis. On the other hand, the Bank of Japan's aggressive monetary easing policy introduced in April further weakened the yen. Despite some short-lived corrections in the middle of the year arising from the market's doubt over "Abenomics", the yen continued to weaken for the rest of the year as the market started to price in the probability of further monetary policy easing in Japan.

The performance of major currency, bond and equity markets in 2013 is shown in Table 1.

Table 1 2013 market returns

Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+4.5%
Yen	–17.7%
Bond markets	
Relevant US Government Bond (1 – 30 years) Index	–3.4%
Equity markets [1]	
Standard & Poor's 500 Index	+29.6%
Hang Seng Index	+2.9%

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

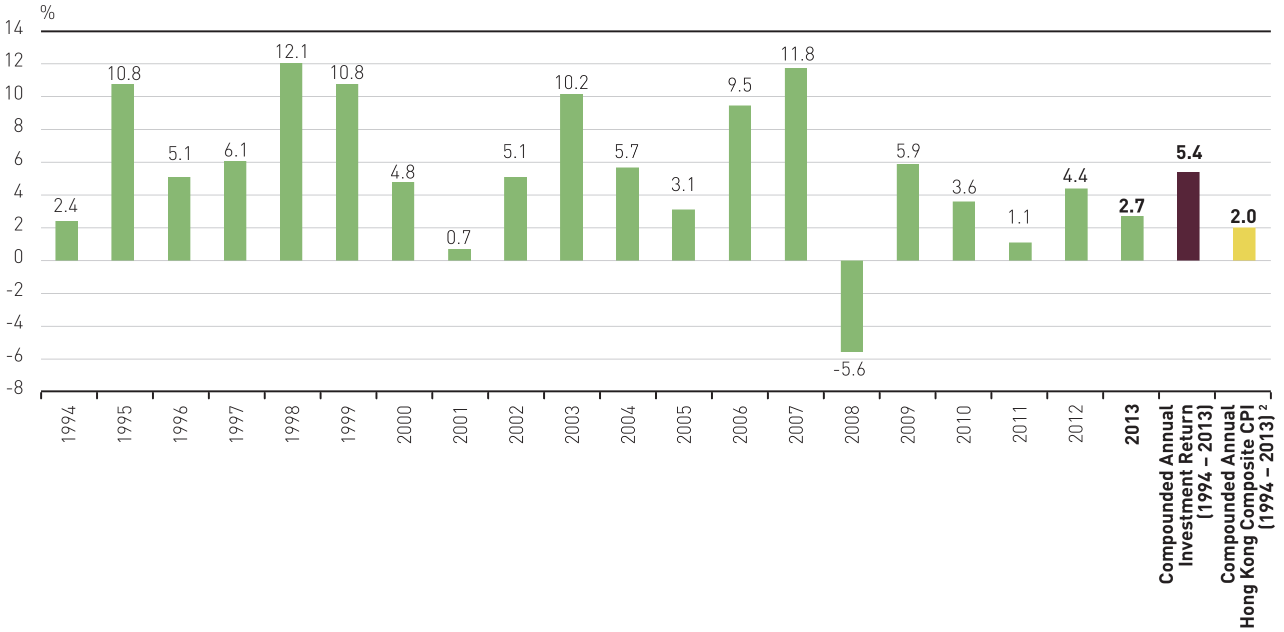
The Exchange Fund's performance

The Exchange Fund recorded an investment income of $81.2 billion in 2013, comprising valuation gains from Hong Kong and foreign equities of $10.1 billion and $71.8 billion respectively, a valuation gain on other investments held by the investment holding subsidiaries of the Fund of $16.8 billion, an exchange valuation gain of $1.6 billion, and a valuation loss of $19.1 billion from bonds. Apart from the $81.2 billion investment income, the valuation loss and dividend income of the Strategic Portfolio amounted to an overall gain of $48 million.

The investment return of the Exchange Fund after excluding the Strategic Portfolio was 2.7%. The annual return of the Fund from 1994 to 2013 is set out in Chart 1. Table 2 shows the 2013 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 2.7% over the past three years, 3.5% over the past five years, 4.1% over the past 10 years and 5.4% since 1994.[1] Table 3 shows the currency mix of the Fund's assets on 31 December 2013.

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

Chart 1 Investment return of the Exchange Fund (1994 – 2013) [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]
2013	2.7%
3-year average (2011 – 2013)	2.7%
5-year average (2009 – 2013)	3.5%
10-year average (2004 – 2013)	4.1%
Average since 1994	5.4%

[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 2013 (including forward transactions)

	HK$ billion	**%**
US dollar	2,250.0	74.2
Hong Kong dollar	278.6	9.2
Others [1]	504.2	16.6
Total	**3,032.8**	**100.0**

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

Corporate Functions

The HKMA maintained effective communications with the community through the media, public education programme and various other channels to facilitate the public's understanding of its policies and operations. During the year, resources were reviewed and strategically deployed to enhance various work-flows to support new initiatives. HKMA staff continued to show enthusiastic support for charity events and took advantage of various training opportunities to enhance their professional skills and knowledge.

CORPORATE DEVELOPMENT

Media relations

The HKMA maintains effective and timely communications with the media to enhance transparency and promote public understanding about its policies and work. In 2013, 69 open press events were held, comprising 15 press conferences, 13 stand-up interviews and 41 other public functions. A further 41 media interviews were arranged. A total of 314 bilingual press releases were issued and a large number of media enquiries were handled every day.

In addition, the HKMA organised media briefings to facilitate better understanding of the HKMA's operations and initiatives on various topics, including prudential supervisory measures for mortgage lending, anti-money laundering, and counterfeit banknotes.

Public enquiries

The Public Enquiry Service handled 9,034 enquiries in 2013, providing an effective channel for the general public to better understand the functions and operation of the HKMA.

About half the enquiries received were related to banking policies and regulations, consumer banking issues, and fraud cases. Notable examples included prudential measures on residential mortgage loans, prevention of money laundering and terrorist financing, the Treat Customers Fairly Charter launched in October, and counterfeit banknotes.

Chart 1 shows the number of public enquiries received since 2010 and Chart 2 provides a breakdown by nature of the enquiries in 2013.

Chart 1 **Total number of public enquiries**

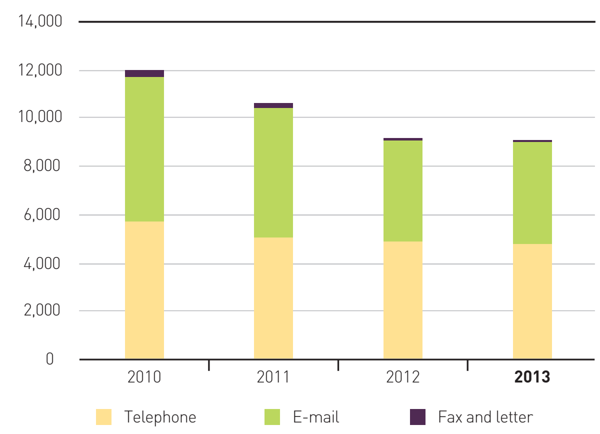
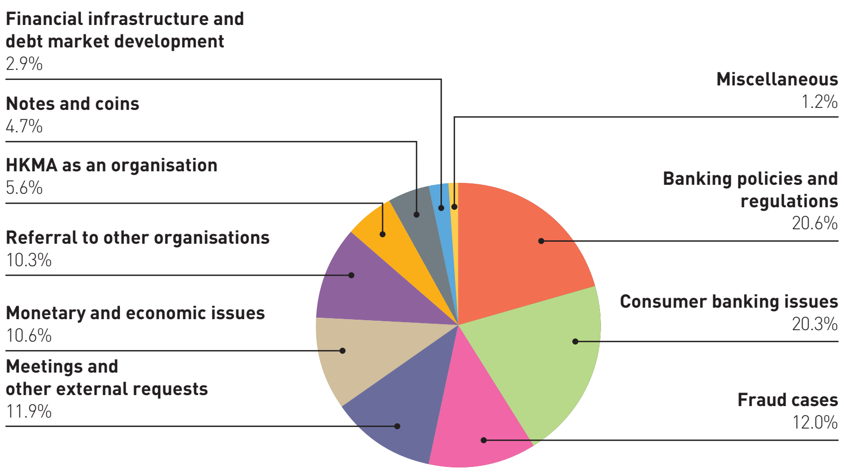


Chart 2 **Nature of enquiries received in 2013**



Note: Figures in this chart may not add up to 100% due to rounding.

Publications

The *HKMA Annual Report*, *Half-Yearly Monetary and Financial Stability Report*, *Quarterly Bulletin* and *Monthly Statistical Bulletin* provide key information on monetary, banking and economic issues in Hong Kong. The HKMA has also published five Background Briefs covering key work areas, such as banking supervision, financial infrastructure and reserves management.

The *HKMA Annual Report 2012* received a Bronze award in the Hong Kong Management Association's 2013 Best Annual Reports Awards.

The HKMA website

The HKMA corporate website (www.hkma.gov.hk), with over 50,000 pages in English and Chinese, provides a convenient way for the public to access up-to-date information about the HKMA. 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. In December 2013, a new feature was introduced to enable visitors to subscribe to automatic e-mail alerts of updates on the website. In December 2012, the HKMA website also implemented the World Wide Web Consortium (W3C) Web Content Accessibility Guidelines (WCAG) 2.0 Level AA standard to improve accessibility for visitors with hearing or visual disabilities.

Public education programme

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

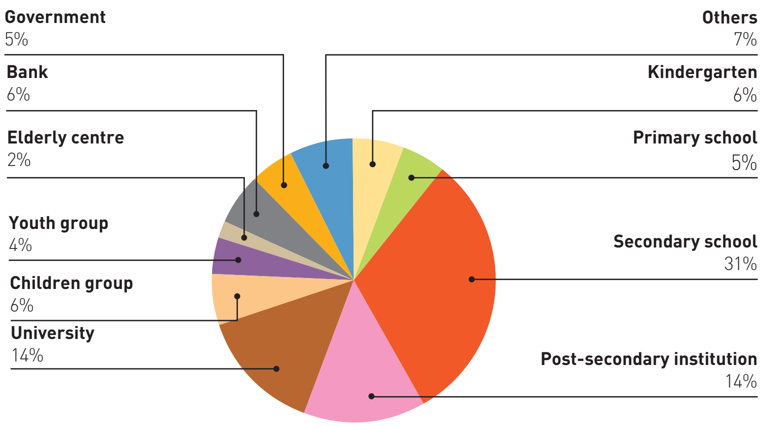
The Centre consists of the Exhibition Area and the Library, and is open to the public six days a week. The Exhibition Area introduces the work of the HKMA and the development of money and banking in Hong Kong. It also contains material and real exhibits for study of Hong Kong's monetary, banking and financial affairs.

In 2013, the Historical Timeline, featuring key milestones of Hong Kong's monetary and banking development, was revamped and updated. A new children's section was added to illustrate the evolution of money in Hong Kong which has proved popular with young visitors.

Guided tours of the Information Centre are also organised for visitors. During the year, the Centre received more than 39,000 visitors and hosted over 520 guided tours for schools and other groups (Chart 3). Over 452,000 people have visited the Information Centre since it opened in December 2003.

The Library, situated next to the Exhibition Area, contains material for the detailed study of Hong Kong's monetary, banking and financial affairs and central banking topics. It also maintains an electronic register of authorized institutions (AIs) in Hong Kong as required by section 20 of the Banking Ordinance.

Chart 3 Types of group visits to the Information Centre



Young visitors learn about currencies in Hong Kong in a guided tour of the Information Centre.

Students and teachers participate in one of the public education seminars.

As part of its community outreach programme, the HKMA continued to organise public education seminars on topics relevant to its work. In 2013, three seminars were held for over 2,200 secondary school students and teachers. Major topics of discussion included the work of the HKMA, the Linked Exchange Rate System, banknotes in Hong Kong, and the smart use of credit cards. Since the launch of the education programme in 1998, more than 50,000 people have participated in the seminars.

HUMAN RESOURCES

The HKMA needs to recruit, develop and maintain a highly professional workforce to support its policy objectives and respond flexibly to changing work priorities. While the HKMA is an integral part of the Government, it is able to employ staff on terms different 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.

Staffing

The establishment of the HKMA in 2013 was 818. During the year, the HKMA conducted a cross-department re-engineering exercise to improve the efficiency of the various work-flows and processes and redeploy some existing resources to support new initiatives. As a result of this rigorous exercise, the overall establishment of the HKMA in 2014 is reduced to 816 (a decrease of 0.2%). Resources were redeployed to undertake the following tasks:

- Preparing for the new regulatory regime which empowers the HKMA to regulate stored value facilities and retail payment systems under the Clearing and Settlement Systems (Amendment) Bill to be introduced into the Legislative Council
- Enhancing banking prudential supervision to focus on banks' key risk areas, including corporate sector credit risk, operational risks, capital and liquidity management. This will help provide a more robust and effective regime to meet the regulatory challenges posed by the increasingly complex operations of universal banking
- Strengthening supervisory and enforcement efforts in anti-money laundering and counter-terrorist financing, in line with the increasing global focus on banks' activities in relation to financial crime and money laundering
- Strengthening the strategic asset allocation process of the Exchange Fund by performing in-depth research and exploring alternative asset allocation models to make the process more comprehensive and accountable for the investment performance of the Exchange Fund
- Enhancing the support to further the expansion of Long-Term Growth Portfolio investment and strengthening related risk management
- Enhancing resources in banking policy development, legal advisory work and organisational risk management.

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 2014

Department	Functions	Senior staff Establishment	Senior staff Strength	Others Establishment	Others Strength
Chief Executive's and Deputy Chief Executives' Offices	Top management of the HKMA.	4	4	7	7
Banking Conduct	To focus on payment systems oversight, licensing, deposit protection and settlement, and all supervisory and development functions relating to the business conduct of AIs.	1	1	100	96
Banking Policy	To formulate supervisory policies for promoting the safety and soundness of the banking sector.	1	1	29	29
Banking Supervision	To supervise day-to-day operations of AIs.	1	1	168	164
Enforcement	To focus on securities enforcement and complaint handling functions.	1	1	59	57
External	To help develop and promote Hong Kong as an international financial centre and to foster regional monetary co-operation through participation in the international central banking and financial community.	1	1	42	40
Financial Infrastructure	To develop and enhance the financial market infrastructure important for maintaining and strengthening Hong Kong as an international financial centre.	1	1	32	32
Monetary Management	To maintain financial and monetary stability through macro-financial surveillance, monitoring of market operations and development issues, and to ensure adequate supply of banknotes and coins.	1	1	41	41
Research	To conduct research and analysis on economic and international financial market developments in Hong Kong and other economies.	1	1	40	40
Reserves Management	To manage reserves to achieve investment returns in line with established guidelines and to enhance the quality of returns by diversifying into different investment markets and asset types.	1	1	56	54
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	31
Office of the General Counsel	To provide in-house legal support and advice.	1	1	21	21
Corporate Services	To provide support services in the form of administrative, finance, human resources, information technology and secretariat services, and to handle media and community relations.	1	1	164	162
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	10
Total		**15**	**15**	**801**	**784**

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) and the Financial Services Development Council, to assist in activities or policy initiatives in which Hong Kong or the HKMA has an interest. Some staff members 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 (or basic pay), which is payable monthly, and variable pay, which may be awarded to individual staff members as a lump sum once a year depending on performance.

Pay for HKMA staff is reviewed annually by the FS in the light of recommendations made to him by the GSC through EFAC, taking into account the GSC's assessment of the performance of the HKMA in the preceding year, the pay survey findings of the financial sector conducted by independent human resources 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. Investment professionals in the HKMA are subject to a variable pay system that seeks to strengthen the linkage between their investment performance and remuneration award. The pay adjustments or awards for 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 members 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 2013 are shown in Table 2.

Table 2 Remuneration packages of HKMA senior staff in 2013[1]

$'000	Chief Executive	Deputy Chief Executive (average)	Executive Director (average)
Number of staff[2]	1	3	14
Annualised pay			
Fixed pay	6,000	5,767	3,452
Variable pay	2,596	1,731	855
Other benefits[3]	1,369	670	492

Notes:

1 Except for annual leave accrued, the actual remuneration received by staff during 2013 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 reflects staff movements during the year. Including the Chief Executive Officer of the Hong Kong Mortgage Corporation, there are 12 posts at the Executive Director rank.

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

As in past years, the HKMA focuses on developing staff capabilities to meet operational demand, career development and new challenges. During the year, HKMA staff were provided with 3,078 training days, including 1,442 days of horizontal training in general skills and 1,636 days of vertical training in job-specific issues. Each staff member received on average 3.9 days of training.

As part of the horizontal training programme, an in-house induction course is held each year for new staff to provide an overview of central banking, and the roles and functions of the HKMA. Workshops on communications and presentation skills, time management, and stress management were also attended by staff of various departments. Other horizontal training programmes organised during the year included team-building workshops for specific departments, language courses, such as English writing skills and Putonghua, and computer skills. An advanced leadership course run by an overseas organisation, and national studies courses organised by the Hong Kong Government at Peking

University and Tsinghua University were attended by managerial staff. Training for senior staff included executive coaching, a locally-run executive leadership programme, a national studies programme conducted by the Chinese Academy of Governance in Beijing, and a central banking seminar organised by the Federal Reserve Bank of New York.

For development of their vertical skills, in-house training on specific topics was organised for Banking departments, covering the latest developments and implementation of the Basel III liquidity standards in Hong Kong, new large exposure rules, complaint handling and investigation skills, investment funds and their latest trends. External consultants were engaged to provide training on advanced bank risk analysis, liquidity risk management and issues relating to the offshore renminbi market in Hong Kong. Staff also participated in courses on corporate credit analysis, corporate failure and protective measures, Islamic capital and money markets run by local professional bodies.

To enhance the knowledge base and professional standards of its staff, the HKMA has been running a Training Sponsorship Scheme to help staff engage in studies at degree, diploma or other professional levels. The 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 to ensure their effectiveness in a changing business environment, and drills on evacuation and the activation of the back-up office are also held annually. The Event Management Team monitors the influenza alerts and other relevant infectious diseases to ensure necessary precautionary and contingency measures are taken in accordance with the Corporate Business Contingency Plan.

An environmental policy is in place and various measures are adopted to protect and preserve the environment. Green office measures include installing energy-saving devices, recycling, and minimising printing and the use of paper products. Green achievements in 2013 included electricity saving by 1.2%, decrease in envelope usage in the main office by 5.5% and reduction in paper consumption by 11%. Staff also continued to participate in regular campaigns for collecting reusable items, such as clothes for donation to charities.

During the year, HKMA staff continued to show unfailing support for charity events. The HKMA Corporate Team was the Champion of the Men's category in the Raleigh Challenge - Wilson Trail "Adventurer — Night Course", and came fifth in the Hong Chi Climbathon. Staff also took part in the Blood Donation Day, the Community Chest's Green Day, Dress Causal Day and Love Teeth Day. In 2013, the HKMA Volunteer Team gave more than 290 hours of free time to serving the community. Team members participated in various volunteer activities organised by the Agency for Volunteer Service, arranged visits for students of the Chak Yan Centre and assisted in the donation of recycled computers and peripherals to the Caritas Computer Workshop. The HKMA has been accredited with the "5 Years Plus Caring Organisation Logo" by the Hong Kong Council of Social Service in recognition of its commitment to corporate citizenship.

HKMA staff members take part in the Blood Donation Day on 31 May 2013.

FINANCE

Annual budget

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

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

The administrative expenditure in 2013 and the budgeted expenditure for core activities in 2014 are shown in Table 3. The difference between the 2013 actual expenditure and the 2014 budget arises mainly from an increase in staff costs due to the full-year effect of staff increases in 2013 and increases in budgets for external relations and professional services. The request for 2014 was approved by the FS on the advice of EFAC.

Table 4 shows other expenses that are not directly related to the HKMA's own operations. Expenses related to the provision of premises for international organisations, whose presence in Hong Kong promotes its status as an international financial centre, are expected to increase by 18% in 2014, mainly due to larger office space required by these organisations. Spending on financial infrastructure is related to providing and expanding payment and other systems to enable markets to function efficiently and securely. 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	2013 Budget*	2013 Actual	2014 Budget*
Staff costs	1,057		1,105
Salaries and other staff costs		910	
Retirement benefit costs		80	
Premises expenses			
Operating lease charges	21	21	25
Other premises expenses (including utility charges and management fees)	49	47	57
General operating costs			
Maintenance of office and computer equipment	74	70	71
Financial information and communication services (including trading, dealing terminals and data link charges)	58	48	53
External relations (including international meetings)	57	30	53
Professional and other services	54	28	56
Training	10	7	10
Others	24	12	16
Total administrative expenditure	**1,404**	**1,253**	**1,446**

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

Table 4 Additional expenses

$ million	2013 Budget*	2013 Actual	2014 Budget*
Subsidy to the Hong Kong Institute for Monetary Research	21	18	22
Premises expenses of international financial organisations in Hong Kong	34	34	40
Service fees for financial infrastructure	146	95	111

* 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 2014, revenue from licence fees is estimated at $131 million (2013: $131 million), and the costs recovered from the Hong Kong Deposit Protection Board and the other income components (excluding investment income) are estimated to total $80 million (2013: $81 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 in terms of financial disclosure. 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 2013 for all time-critical systems.

To meet the Banking Departments' evolving needs for IT support in discharging their responsibilities, the existing banking supervisory information system continues to be upgraded. This covers three main areas – new system infrastructure, the development of business intelligence tools and enhancement of the existing banking return electronic submission system. The new business intelligence and work-flow features will help the HKMA to oversee various supervisory issues, keep track of work targets and ensure that supervisory work will be carried out according to procedures with a clear audit trail. The project is expected to be operational in the second half of 2014.

To ensure continued reliability of the HKMA's IT systems, ageing components of the IT infrastructure were updated in batches. The Division also explored alternative office automation services, including assessing the feasibility of migrating to a Virtual Desktop Infrastructure (VDI) platform. The VDI platform will be introduced in the first half of 2014.

IT security continued to be the Division's high priority task. The IT security information and event management software provided extremely effective early security warning to prevent possible security attacks. With advances in mobile technology, the Division continued to explore and deploy new arrangements for supporting staff on the move to enhance productivity. The Division also participated in the Hong Kong Police's Cyber Security Centre activities.

SETTLEMENT SERVICES

The Settlement Section provides settlement and operational support to ensure the sufficient and reliable transfer of funds or assets of the Exchange Fund arising from reserves management, monetary operations and other activities, as well as for the administration of the HKMA. In view of the potential settlement risks from a broad range of transactions involving different 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 is also dedicated to enhancing operational controls and settlement infrastructure with the ultimate aim of delivering greater accuracy, control and efficiency for the HKMA's funds and assets transfers.

The Settlement Section is committed to effective risk control mechanisms for settlement and operational support. To ensure proper segregation of duties and avoid potential conflicts of interest between the monetary operations and reserves management functions of the HKMA, the Section is grouped under the Banking Conduct Department, which is separated from other HKMA functions.

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 15 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:

- facilitation of the IMF's 2013 assessment of the Hong Kong Special Administrative Region pursuant to its Financial Sector Assessment Programme by providing assistance on the self-assessment exercise regarding the International Organization of Securities Commissions's "Objectives and Principles of Securities Regulation"
- providing assistance on the self-assessment exercise regarding the Basel *Core Principles for Effective Banking Supervision* conducted by the IMF
- continued development and promotion of Islamic finance initiatives, including conducting a feasibility study on sukuk issuance in Hong Kong and co-operation with the central bank of Malaysia
- formulation and implementation of the regulatory regime for the over-the-counter (OTC) derivatives market, including establishing a trade repository in Hong Kong for OTC derivatives transactions and publishing oversight guidelines
- formulation of the proposed regulatory regime for stored value facilities and retail payment systems
- formulation of proposals for regulating insurance intermediation services offered by AIs as part of the new regulatory regime for the insurance industry
- deliberation on effective resolution regimes to strengthen cross-border resolution for global systemically important financial institutions, including participation in the Financial Stability Board (FSB) Resolution Steering Group and Information Sharing Workstream, 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 new Companies Ordinance. 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 controls, risk management and governance processes, and advises on opportunities for improvement. The Division reports directly to the Chief Executive of the HKMA and the Audit Sub-Committee of EFAC.

Using a risk-based approach, operational audits and system security reviews were conducted to cover all significant risks of the HKMA. The Division also advised on major system development projects and responded to management requests on internal control matters, including giving advice to senior executives on internal control issues. During the year, the Division strengthened its role by providing quarterly updates of the organisation-wide risk assessment which enabled the Risk Committee to more timely assess risks of all business units in a macro-perspective.

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. Both Committees are chaired by the Chief Executive of the HKMA.

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 the 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 authorization and controls.

In view of the growing complexity of the HKMA's work and the increasing public expectation of the organisation, the operational risk management process has been strengthened. Specifically, the framework now covers organisational risks at two levels: entity-level and department-level. Entity-level risks mainly refer to those which concern the entire organisation in the medium term, or which might call for a cross-departmental response. In general, potential or emerging risks identified by the business units, and the adequacy of the control measures and mitigating strategies they devise, are reported and reviewed on a quarterly basis. This is supplemented by a top-down approach to manage entity-level risks, in which senior colleagues actively identify risks of wider impact and propose mitigating measures. These assessments are discussed at the Risk Committee, at which appropriate follow-up actions are decided.

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 124 to 215, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2013, 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 2013, 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.

David Sun
Director of Audit

4 April 2014

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

Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2013

(Expressed in millions of Hong Kong dollars)	Note	Group 2013	Group 2012	Fund 2013	Fund 2012
INCOME					
Interest income		**17,168**	17,570	**15,742**	15,971
Dividend income		**11,494**	10,650	**11,806**	10,324
Income from investment properties		**1,823**	253	**–**	–
Net realised and unrealised gains		**40,000**	83,998	**35,287**	81,082
Net exchange gain/(loss)		**1,420**	(1,552)	**1,555**	(1,435)
Investment income	4(a)	**71,905**	110,919	**64,390**	105,942
Bank licence fees		**131**	132	**131**	132
Other income		**592**	641	**98**	104
TOTAL INCOME		**72,628**	111,692	**64,619**	106,178
EXPENDITURE					
Interest expense on placements by Fiscal Reserves, HKSAR government funds and statutory bodies	4(b)	**(46,047)**	(45,757)	**(46,047)**	(45,757)
Other interest expense	4(c)	**(1,927)**	(1,662)	**(1,255)**	(1,221)
Operating expenses	4(d)	**(3,993)**	(3,252)	**(3,251)**	(2,884)
Note and coin expenses	4(e)	**(442)**	(346)	**(442)**	(346)
Write back of impairment losses on loans		**3**	6	**–**	–
TOTAL EXPENDITURE		**(52,406)**	(51,011)	**(50,995)**	(50,208)
SURPLUS BEFORE SHARE OF PROFIT OF ASSOCIATES AND JOINT VENTURES		**20,222**	60,681	**13,624**	55,970
Share of profit of associates and joint ventures, net of tax		**688**	654	**–**	–
Gain from disposal of a joint venture		**–**	7	**–**	–
SURPLUS BEFORE TAXATION		**20,910**	61,342	**13,624**	55,970
Income tax	5	**(117)**	(3)	**–**	–
SURPLUS FOR THE YEAR		**20,793**	61,339	**13,624**	55,970
ATTRIBUTABLE TO:					
Owner of the Fund		**20,721**	61,300	**13,624**	55,970
Non-controlling interests		**72**	39	**–**	–
		20,793	61,339	**13,624**	55,970

The notes on pages 130 to 215 form part of these financial statements.

Exchange Fund – Statement of Comprehensive Income

for the year ended 31 December 2013

(Expressed in millions of Hong Kong dollars)	Note	Group 2013	Group 2012	Fund 2013	Fund 2012
SURPLUS FOR THE YEAR		**20,793**	61,339	**13,624**	55,970
OTHER COMPREHENSIVE INCOME					
Items that may be reclassified subsequently to income and expenditure account					
Available-for-sale securities					
fair value changes on revaluation	31	**9,884**	2,259	**–**	–
fair value changes on disposal transferred to income and expenditure account	31	**(296)**	(38)	**–**	–
tax effect	31	**55**	(53)	**–**	–
Cash flow hedges					
fair value changes transferred to income and expenditure account	31	**4**	6	**–**	–
tax effect	31	**(1)**	(1)	**–**	–
Exchange differences on translation of financial statements of overseas subsidiaries and joint ventures	31	**38**	1	**–**	–
Reserves released on disposal of a joint venture	31	**–**	(7)	**–**	–
OTHER COMPREHENSIVE INCOME FOR THE YEAR, NET OF TAX		**9,684**	2,167	**–**	–
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		**30,477**	63,506	**13,624**	55,970
TOTAL COMPREHENSIVE INCOME FOR THE YEAR ATTRIBUTABLE TO:					
Owner of the Fund		**30,404**	63,467	**13,624**	55,970
Non-controlling interests		**73**	39	**–**	–
		30,477	63,506	**13,624**	55,970

The notes on pages 130 to 215 form part of these financial statements.

Exchange Fund – Balance Sheet

as at 31 December 2013

(Expressed in millions of Hong Kong dollars)	Note	Group 2013	Group 2012	Fund 2013	Fund 2012
ASSETS					
Cash and money at call	7	**128,692**	51,353	**127,739**	49,978
Placements with banks and other financial institutions	8	**176,632**	148,042	**165,080**	138,332
Assets held for sale	9	**130**	–	**–**	–
Financial assets designated at fair value	10	**2,616,788**	2,492,917	**2,603,501**	2,479,796
Available-for-sale securities	11	**66,172**	43,608	**493**	493
Derivative financial instruments	12(a)	**5,000**	6,175	**3,492**	4,429
Held-to-maturity securities	13	**8,624**	9,324	**–**	–
Loan portfolio	14	**22,268**	25,895	**–**	–
Gold	15	**622**	862	**622**	862
Other assets	16	**61,168**	49,313	**60,232**	48,332
Interests in subsidiaries	17	**–**	–	**68,545**	55,699
Interests in associates and joint ventures	18	**9,431**	5,242	**–**	–
Investment properties	19	**17,695**	16,380	**–**	–
Property, plant and equipment	20(a)	**3,332**	3,339	**3,114**	3,176
TOTAL ASSETS		**3,116,554**	2,852,450	**3,032,818**	2,781,097
LIABILITIES AND EQUITY					
Certificates of Indebtedness	21	**327,372**	289,837	**327,372**	289,837
Government-issued currency notes and coins in circulation	21	**10,575**	9,934	**10,575**	9,934
Balance of the banking system	22	**164,093**	255,851	**164,093**	255,851
Placements by banks and other financial institutions	23	**50,734**	–	**50,734**	–
Placements by Fiscal Reserves	24	**773,862**	717,536	**773,862**	717,536
Placements by Hong Kong Special Administrative Region government funds and statutory bodies	25	**214,911**	167,913	**214,911**	167,913
Exchange Fund Bills and Notes issued	26	**782,605**	688,214	**782,605**	688,484
Derivative financial instruments	12(a)	**4,347**	2,593	**3,124**	1,652
Bank loans	27	**9,525**	9,250	**–**	–
Mortgage-backed securities issued	28	**–**	214	**–**	–
Other debt securities issued	29	**31,335**	36,365	**–**	–
Other liabilities	30	**75,004**	33,044	**68,034**	26,006
Total liabilities		**2,444,363**	2,210,751	**2,395,310**	2,157,213
Accumulated surplus	31	**657,989**	637,268	**637,508**	623,884
Revaluation reserve	31	**13,563**	3,917	**–**	–
Translation reserve	31	**73**	36	**–**	–
Total equity attributable to owner of the Fund		**671,625**	641,221	**637,508**	623,884
Non-controlling interests	31	**566**	478	**–**	–
Total equity		**672,191**	641,699	**637,508**	623,884
TOTAL LIABILITIES AND EQUITY		**3,116,554**	2,852,450	**3,032,818**	2,781,097

Norman T. L. Chan
Monetary Authority
4 April 2014

The notes on pages 130 to 215 form part of these financial statements.

Exchange Fund – Statement of Changes in Equity

for the year ended 31 December 2013

		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 2012		575,968	1,744	42	577,754	282	578,036
Surplus for the year	31	61,300	–	–	61,300	39	61,339
Other comprehensive income/(loss) for the year	31	–	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	31	–	–	–	–	167	167
Dividends paid to non-controlling interests	31	–	–	–	–	(10)	(10)
At 31 December 2012		637,268	3,917	36	641,221	478	641,699
At 1 January 2013		**637,268**	**3,917**	**36**	**641,221**	**478**	**641,699**
Surplus for the year	31	**20,721**	**–**	**–**	**20,721**	**72**	**20,793**
Other comprehensive income for the year	31	**–**	**9,646**	**37**	**9,683**	**1**	**9,684**
Total comprehensive income for the year		**20,721**	**9,646**	**37**	**30,404**	**73**	**30,477**
Capital injection by non-controlling interests	31	**–**	**–**	**–**	**–**	**38**	**38**
Dividends paid to non-controlling interests	31	**–**	**–**	**–**	**–**	**(23)**	**(23)**
At 31 December 2013		**657,989**	**13,563**	**73**	**671,625**	**566**	**672,191**
Fund							
At 1 January 2012		567,914	–	–	567,914	–	567,914
Surplus and total comprehensive income for the year	31	55,970	–	–	55,970	–	55,970
At 31 December 2012		623,884	–	–	623,884	–	623,884
At 1 January 2013		**623,884**	**–**	**–**	**623,884**	**–**	**623,884**
Surplus and total comprehensive income for the year	31	**13,624**	**–**	**–**	**13,624**	**–**	**13,624**
At 31 December 2013		**637,508**	**–**	**–**	**637,508**	**–**	**637,508**

The notes on pages 130 to 215 form part of these financial statements.

Exchange Fund – Statement of Cash Flows

for the year ended 31 December 2013

(Expressed in millions of Hong Kong dollars)	Note	Group 2013	Group 2012	Fund 2013	Fund 2012
Cash flows from operating activities					
Surplus before taxation		**20,910**	61,342	**13,624**	55,970
Adjustments for:					
Interest income	4(a)	**(17,168)**	(17,570)	**(15,742)**	(15,971)
Dividend income	4(a)	**(11,494)**	(10,650)	**(11,806)**	(10,324)
Change in fair value of investment properties	4(a)	**(816)**	133	**–**	–
Net gains on disposal of available-for-sale securities	4(a)	**(2,590)**	(1,110)	**–**	–
Net gains on disposal of held-to-maturity securities	4(a)	**–**	(5)	**–**	–
Interest expense	4(b) & 4(c)	**47,974**	47,419	**47,302**	46,978
Depreciation	4(d)	**172**	160	**130**	121
Share of profit of associates and joint ventures		**(688)**	(654)	**–**	–
Gain from disposal of a joint venture		**–**	(7)	**–**	–
Net loss on disposal of property, plant and equipment		**1**	–	**–**	–
Elimination of exchange differences and other non-cash items		**(615)**	389	**(356)**	350
Interest received		**19,002**	18,317	**17,453**	16,680
Interest paid		**(48,011)**	(47,370)	**(47,336)**	(47,043)
Dividends received		**11,335**	10,953	**10,847**	10,284
Income tax paid		**(58)**	(131)	**–**	–
		17,954	61,216	**14,116**	57,045
Change in fair value of derivatives and other debt securities issued		**1,710**	(824)	**2,413**	(655)
Change in carrying amount of:					
– placements with banks and other financial institutions		**(2,616)**	(8,676)	**(1,149)**	(402)
– cash transferred to assets held for sale		**(129)**	–	**–**	–
– financial assets designated at fair value		**(206,503)**	(185,848)	**(206,337)**	(181,907)
– loan portfolio		**3,629**	7,244	**–**	–
– gold		**240**	(45)	**240**	(45)
– other assets		**(13,554)**	(26,610)	**(13,434)**	(26,836)
– Certificates of Indebtedness, government-issued currency notes and coins in circulation		**38,176**	31,181	**38,176**	31,181
– balance of the banking system		**(91,758)**	107,167	**(91,758)**	107,167
– placements by banks and other financial institutions		**50,734**	(24,547)	**50,734**	(24,547)
– placements by Fiscal Reserves		**56,326**	54,029	**56,326**	54,029
– placements by Hong Kong Special Administrative Region government funds and statutory bodies		**46,998**	41,664	**46,998**	41,664
– Exchange Fund Bills and Notes issued		**94,391**	32,464	**94,121**	32,734
– other liabilities		**42,054**	(5,800)	**42,062**	(6,048)
Net cash from operating activities		**37,652**	82,615	**32,508**	83,380

Exchange Fund – Statement of Cash Flows (continued)

for the year ended 31 December 2013

		Group		Fund	
(Expressed in millions of Hong Kong dollars)	Note	**2013**	2012	**2013**	2012
Cash flows from investing activities					
Net cash outflow from acquisition of a subsidiary		**–**	(690)	**–**	–
Loans to subsidiaries		**–**	–	**(12,846)**	(22,421)
Increase in interests in joint ventures		**(3,493)**	(4,292)	**–**	–
Proceeds from sale or redemption of available-for-sale securities		**12,180**	4,327	**–**	–
Purchase of available-for-sale securities		**(22,551)**	(21,138)	**–**	–
Proceeds from sale or redemption of held-to-maturity securities		**2,783**	971	**–**	–
Purchase of held-to-maturity securities		**(2,055)**	(1,926)	**–**	–
Proceeds from disposal of a joint venture		**–**	137	**–**	–
Purchase of investment properties		**–**	(5,191)	**–**	–
Purchase of property, plant and equipment		**(166)**	(76)	**(68)**	(59)
Dividends received from subsidiaries		**–**	–	**778**	363
Net cash used in investing activities		**(13,302)**	(27,878)	**(12,136)**	(22,117)
Cash flows from financing activities					
Bank loans raised		**–**	3,209	**–**	–
Proceeds from issue of other debt securities		**18,128**	19,077	**–**	–
Redemption of mortgage-backed securities issued		**(214)**	(153)	**–**	–
Redemption of other debt securities issued		**(21,966)**	(23,661)	**–**	–
Capital injection by non-controlling interests		**38**	167	**–**	–
Dividends paid to non-controlling interests		**(23)**	(10)	**–**	–
Net cash used in financing activities		**(4,037)**	(1,371)	**–**	–
Net increase in cash and cash equivalents		**20,313**	53,366	**20,372**	61,263
Cash and cash equivalents at 1 January		**307,813**	254,791	**305,300**	244,387
Effect of foreign exchange rate changes		**368**	(344)	**356**	(350)
Cash and cash equivalents at 31 December	32	**328,494**	307,813	**326,028**	305,300

The notes on pages 130 to 215 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 four portfolios: the Backing Portfolio, the Investment Portfolio, the Long-Term Growth Portfolio and the Strategic Portfolio. The assets of the Backing Portfolio fully match the Monetary Base, under Hong Kong's Currency Board system. 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. The Long-Term Growth Portfolio holds private equity and real estate investments. 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. Operating segment information is set out in note 33.

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 17 and 18.

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 values as explained in the accounting policies set out below:

- trading financial instruments (note 2.6.2.1);
- financial assets and financial liabilities designated at fair value (note 2.6.2.2);
- available-for-sale securities (note 2.6.2.5);
- gold (note 2.12); and
- investment properties (note 2.13).

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 19 contains information about the assumptions relating to fair value estimation of investment properties. Note 39 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.

2.3 Subsidiaries and non-controlling interests

A subsidiary is an entity controlled by the Group. The Group controls an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. When assessing whether the Group has power, only substantive rights (held by the Group and other parties) are considered.

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, transactions and cash flows and 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 2.15).

For acquisition of assets that do 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 acquisitions do not give rise to any goodwill.

2.4 Associates and joint ventures

An associate is an entity in which the Group has significant influence, but not control or joint control, over its management, through its power to participate in the financial and operating policy decisions.

A joint venture is a type of joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Joint control is the contractually agreed sharing of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

An investment in an associate or a joint venture is accounted for in the Group financial statements under the equity method and is initially recorded at cost, adjusted for any excess or deficit 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 associates and the joint ventures for the year. When the Group's share of losses exceeds its interest in the associates 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 associates 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 associates or the joint ventures.

Unrealised profits and losses resulting from transactions between the Group and its associates and joint ventures are eliminated to the extent of the Group's interests in the associates 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 2.6.1) or, when appropriate, the cost on initial recognition of an investment in an associate.

In the balance sheet of the Fund, its investments in associates and joint ventures are stated at cost less impairment losses, if any (note 2.15).

2.5 Fair value measurement

The Group measures certain financial instruments, all investment properties and gold at fair value at each balance sheet date. The fair values of financial instruments measured at amortised cost are disclosed in note 39.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurement is based on the presumption that the transaction to sell the asset or transfer the liability takes place either:

(a) in the principal market for the asset or liability, or

(b) in the absence of a principal market, in the most advantageous market for the asset or liability.

The principal or the most advantageous market must be accessible by the Group.

The fair value of an asset or a liability is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset for its highest and best use.

The Group uses valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

The Group measures fair values using the following fair value hierarchy that reflects the significance of inputs used in making the measurements:

(a) Level 1 – fair values are quoted prices (unadjusted) in active markets for identical assets or liabilities;

(b) Level 2 – fair values 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

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

For assets and liabilities that are recognised in the financial statements on a recurring basis, the Group determines whether transfers have occurred between levels in the hierarchy by re-assessing categorisation (based on the lowest level input that is significant to the fair value measurement as a whole) at the balance sheet date.

2.6 Financial assets and financial liabilities

2.6.1 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 6.

Financial assets and financial liabilities are measured initially at fair value 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.

2.6.2 Categorisation

2.6.2.1 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 2.10) 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.

2.6.2.2 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.

2.6.2.3 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 2.11).

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.

2.6.2.4 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 2.11).

2.6.2.5 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 2.11). Foreign exchange gains and losses on monetary items are recognised in the income and expenditure account. Foreign exchange gains and losses on non-monetary items are recognised in other comprehensive income.

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 2.11).

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.

2.6.2.6 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 2.6.2.7), 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.

2.6.2.7 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 using the closing exchange rate at the balance sheet date.

2.6.3 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.

2.6.4 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.

2.6.5 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 2.6.2). The embedded derivative is measured at fair value with change in fair value recognised in the income and expenditure account.

2.7 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. 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.

2.8 Securities lending agreements

Where securities are loaned with the receipt of cash or other securities as collateral, they are retained on the balance sheet and measured in accordance with the measurement principles as stated in note 2.5. 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.

2.9 Non-current assets held for sale

A non-current asset (or disposal group) is classified as held for sale if it is highly probable that its carrying amount will be recovered through a sale transaction rather than through continuing use and the asset (or disposal group) is available for sale in its present condition. A disposal group is a group of assets to be disposed of together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

On initial classification as held for sale and until disposal, the non-current assets (except for certain assets as explained below), or disposal groups, are recognised at the lower of their carrying amount and fair value less costs to sell. Deferred tax assets, financial assets (other than investments in subsidiaries, associates and joint ventures) and investment properties, even if held for sale, would continue to be measured in accordance with the policies set out elsewhere in note 2.

2.10 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.

2.10.1 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.

2.10.2 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.

2.11 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. 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. For exposures which are not individually significant, the Group will assess impairment collectively.

If any such evidence exists, the carrying amount of the financial asset 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 equity securities 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.

2.12 Gold

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

2.13 Investment properties

Properties that are held for long-term rental yields, 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 as assessed by independent professional valuers. Fair values of the investment properties are measured based on the market or income approach. Under the market approach, the value is determined based on comparable transactions. For the income approach, the fair value is determined using valuation techniques including discounted cash flows and income capitalisation methods.

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.

2.14 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 2.15):

– 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; and

– plant and equipment, including plant, machinery, furniture, fixtures, equipment, motor vehicles and personal computers.

Intangible assets including computer software licences and system development costs are included in property, plant and equipment.

Freehold land is not depreciated. For other items of property, plant and equipment, depreciation is calculated to write off their cost less their estimated residual value, if any, on a straight-line basis over their estimated useful lives as follows:

– leasehold land classified as held under a finance lease	over the unexpired term of lease
– buildings situated on freehold land	39 years
– buildings situated on leasehold land	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.

2.15 Impairment of other assets

The carrying amounts of other assets, including investments in subsidiaries, investments in associates 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.

2.16 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.

2.17 Revenue and expenditure recognition

2.17.1 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 24 and 25). 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.

2.17.2 Net realised and unrealised 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 unrealised gains or losses in the income and expenditure account in the period in which they arise.

2.17.3 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 unconditionally 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.

2.17.4 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.

2.17.5 Rental payments under operating leases

Leases where substantially all the rewards and risks of ownership remain with the lessor 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.

2.17.6 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.

2.18 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 gain/(loss)" in the income and expenditure account. Although it is not practicable to disclose separately the net exchange gain/(loss) 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.

2.19 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.

2.20 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, the Long-Term Growth 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 33.

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. Of these, the following are relevant to the Group financial statements:

– Amendments to HKAS 1, Presentation of Financial Statements – Presentation of Items of Other Comprehensive Income;

– HKFRS 10, Consolidated Financial Statements;

– HKFRS 11, Joint Arrangements;

– HKFRS 12, Disclosure of Interests in Other Entities; and

– HKFRS 13, Fair Value Measurement.

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (note 40). Impact of the adoption of the above new or revised HKFRSs is discussed below.

3.1 Amendments to HKAS 1, Presentation of Financial Statements – Presentation of Items of Other Comprehensive Income

The amendments to HKAS 1 require entities to present separately the items of other comprehensive income that would be reclassified to income and expenditure account in the future if certain conditions are met from those that would never be reclassified to income and expenditure account. The presentation of other comprehensive income in the statement of comprehensive income in these financial statements has been modified accordingly.

The amendments also introduce a new terminology for the "Income and Expenditure Account" to be renamed as the "Statement of Profit or Loss". The use of this new terminology is not mandatory. The Group has chosen to retain the title of "Income and Expenditure Account".

3.2 HKFRS 10, Consolidated Financial Statements

HKFRS 10 introduces a single control model to determine whether an investee should be consolidated, by focusing on whether the entity has power over the investee, exposure or rights to variable returns from its involvement with the investee and the ability to use its power to affect the amount of those variable returns. The adoption of HKFRS 10 does not change any of the control conclusions reached by the Group in respect of its involvement with other entities.

3.3 HKFRS 11, Joint Arrangements

HKFRS 11 divides joint arrangements into joint operations and joint ventures. Entities are required to determine the type of an arrangement by considering the structure, legal form, contractual terms and other facts and circumstances relevant to their rights and obligations under the arrangement. Joint arrangements which are classified as joint operations under HKFRS 11 are recognised on a line-by-line basis to the extent of the joint operator's interest in the joint operation. All other joint arrangements are classified as joint ventures under HKFRS 11 and are required to be accounted for using the equity method in the Group's financial statements. There is no impact on the Group's financial statements arising from the adoption of HKFRS 11.

3.4 HKFRS 12, Disclosure of Interests in Other Entities

HKFRS 12 brings together into a single standard all the disclosure requirements relevant to an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. The disclosures required in HKFRS 12 are generally more extensive than those previously required by the respective standards. To the extent that the requirements are applicable to the Group, the Group has provided those disclosures in notes 17 and 18.

3.5 HKFRS 13, Fair Value Measurement

HKFRS 13 replaces existing guidance in individual HKFRSs with a single source of fair value measurement guidance. HKFRS 13 also contains extensive disclosure requirements about fair value measurements for both financial instruments and non-financial assets. To the extent that the requirements are applicable to the Group, the Group has provided those disclosures in notes 15, 19 and 39.

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

4 INCOME AND EXPENDITURE

(a) Investment income

	Group		Fund	
	2013	2012	**2013**	2012
Interest income:				
– from derivative financial instruments	**403**	414	**403**	414
– from financial assets designated at fair value	**14,972**	15,410	**14,718**	15,060
– from other financial assets	**1,793**	1,746	**621**	497
	17,168	17,570	**15,742**	15,971
Dividend income:				
– from financial assets designated at fair value	**11,116**	10,114	**11,013**	9,959
– from other financial assets	**378**	536	**15**	15
– from subsidiaries	**–**	–	**778**	350
	11,494	10,650	**11,806**	10,324
Income from investment properties:				
– rental income	**1,007**	386	**–**	–
– change in fair value on revaluation	**816**	(133)	**–**	–
	1,823	253	**–**	–
Net realised and unrealised gains/(losses):				
– on derivative financial instruments	**(5,567)**	4,059	**(5,033)**	4,057
– on financial assets and financial liabilities designated at fair value	**42,977**	78,824	**40,320**	77,025
– on disposal of available-for-sale securities	**2,590**	1,110	**–**	–
– on disposal of held-to-maturity securities	**–**	5	**–**	–
	40,000	83,998	**35,287**	81,082
Net exchange gain/(loss)	**1,420**	(1,552)	**1,555**	(1,435)
TOTAL	**71,905**	110,919	**64,390**	105,942

(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	
	2013	2012
Interest on placements by Fiscal Reserves:		
– at a fixed rate determined annually[1]	**36,791**	37,749
– at market-based rates	**1**	1
Interest on placements by HKSAR government funds and statutory bodies:		
– at a fixed rate determined annually[1]	**9,253**	8,006
– at market-based rates	**2**	1
TOTAL	**46,047**	45,757

1 This rate has been fixed at 5% per annum for 2013 (2012: 5.6% – notes 24 and 25).

(c) Other interest expense

	Group		Fund	
	2013	2012	**2013**	2012
Interest on Exchange Fund Bills and Notes issued	**1,251**	1,168	**1,251**	1,168
Interest expense on derivative financial instruments	**198**	88	**–**	22
Interest expense on other debt securities issued designated at fair value and trading liabilities	**4**	17	**3**	15
Interest expense on other financial liabilities	**474**	389	**1**	16
TOTAL	**1,927**	1,662	**1,255**	1,221

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

(d) Operating expenses

	Group		Fund	
	2013	2012	**2013**	2012
Staff costs				
Salaries and other staff costs	**1,093**	1,012	**910**	834
Retirement benefit costs	**91**	79	**80**	69
Premises and equipment expenses				
Depreciation	**172**	160	**130**	121
Rental expenses under operating leases	**70**	58	**51**	45
Other premises expenses	**67**	59	**51**	48
General operating costs				
Maintenance of office and computer equipment	**79**	68	**70**	60
Financial information and communication services	**54**	50	**48**	44
External relations	**37**	39	**30**	30
Service fees for financial infrastructure	**95**	80	**95**	80
Professional and other services	**98**	54	**28**	26
Training	**8**	9	**7**	8
Operating expenses relating to investment properties	**90**	23	**–**	–
Others	**26**	34	**30**	39
Investment management and custodian fees				
Management and custodian fees	**1,287**	885	**1,058**	844
Transaction costs	**239**	170	**176**	165
Withholding tax	**460**	432	**460**	432
Others	**27**	40	**27**	39
TOTAL	**3,993**	3,252	**3,251**	2,884

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

	Group	
	2013	2012
Fixed pay	**65.8**	64.3
Variable pay	**17.8**	18.1
Other benefits	**9.5**	7.9
	93.1	90.3

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 shown in the below table. The number of senior staff posts remained at 16. The increase in 2013 reflects staff movements during the year.

	Group	
HK$	**2013**	2012
1,500,001 to 2,000,000	**1**	–
2,000,001 to 2,500,000	**1**	–
2,500,001 to 3,000,000	**1**	–
3,000,001 to 3,500,000	**2**	–
4,000,001 to 4,500,000	**3**	6
4,500,001 to 5,000,000	**1**	2
5,000,001 to 5,500,000	**2**	2
5,500,001 to 6,000,000	**2**	1
6,000,001 to 6,500,000	**1**	1
7,000,001 to 7,500,000	**–**	1
7,500,001 to 8,000,000	**1**	1
8,000,001 to 8,500,000	**2**	1
9,000,001 to 9,500,000	**–**	1
9,500,001 to 10,000,000	**1**	–
	18	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 INCOME TAX

(a) Income tax charged in the income and expenditure account

	Group		Fund	
	2013	2012	**2013**	2012
Current tax				
Provision for the year				
– Hong Kong	**84**	98	**–**	–
– Taxation outside Hong Kong	**9**	5	**–**	–
Deferred tax				
Charge/(credit) for current year	**24**	(100)	**–**	–
	117	3	**–**	–

No provision for Hong Kong profits tax has been made for the Fund as it is an integral part of the government. The provision for Hong Kong profits tax relates to the tax liabilities of the Fund's subsidiaries. For 2013, it is calculated at 16.5% (2012: 16.5%) of the estimated assessable profits for the year. Tax for overseas subsidiaries is charged at the appropriate current rates of taxation ruling in the relevant countries.

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

Reconciliation between tax expense and accounting profit at applicable tax rates:

	Group		Fund	
	2013	2012	**2013**	2012
Surplus before taxation	**20,910**	61,342	**13,624**	55,970
Surplus subject to tax in Hong Kong and elsewhere	**2,674**	1,445	**–**	–
Tax calculated at domestic tax rates in the respective countries	**408**	299	**–**	–
Tax effect of:				
non-deductible expenses	**68**	143	**–**	–
non-taxable income	**(326)**	(359)	**–**	–
tax losses not recognised	**1**	4	**–**	–
recognition of previously unrecognised deferred tax positions	**(42)**	(55)	**–**	–
others	**8**	(29)	**–**	–
Actual tax expense	**117**	3	**–**	–

(b) Tax payable

	Group		Fund	
	2013	2012	**2013**	2012
Tax payable	**155**	108	**–**	–

(c) Deferred tax

		Group		Fund	
	Note	**2013**	2012	**2013**	2012
Net deferred tax assets	16	**(63)**	(92)	**–**	–
Net deferred tax liabilities	30	**90**	149	**–**	–
		27	57	**–**	–

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

The major components of deferred tax (assets)/liabilities and the movements during the year are as follows:

	Group				
	Adjustments on bank loans and derivative financial instruments	**Fair value change**	**Accelerated tax depreciation**	**Others**	**Net deferred tax (assets)/ liabilities**
At 1 January 2012	–	60	31	(12)	79
Charged/(credited) to the income and expenditure account	(113)	35	(25)	3	(100)
Charged to other comprehensive income	–	53	–	1	54
Acquisition of a subsidiary	–	–	26	–	26
Exchange differences	(4)	2	–	–	(2)
At 31 December 2012	(117)	150	32	(8)	57
At 1 January 2013	**(117)**	**150**	**32**	**(8)**	**57**
Charged/(credited) to the income and expenditure account	**54**	**(31)**	**(6)**	**7**	**24**
Charged/(credited) to other comprehensive income	**–**	**(55)**	**–**	**1**	**(54)**
Exchange differences	**6**	**(6)**	**–**	**–**	**–**
At 31 December 2013	**(57)**	**58**	**26**	**–**	**27**

There was no significant unprovided deferred tax as at 31 December 2013 and 2012.

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

6 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

		Group – 2013						
	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	7	128,692	–	–	128,692	–	–	–
Placements with banks and other financial institutions	8	176,632	–	–	176,632	–	–	–
Financial assets designated at fair value	10	2,616,788	–	2,616,788	–	–	–	–
Available-for-sale securities	11	66,172	–	–	–	–	66,172	–
Derivative financial instruments	12(a)	5,000	5,000	–	–	–	–	–
Held-to-maturity securities	13	8,624	–	–	–	8,624	–	–
Loan portfolio	14	22,268	–	–	22,268	–	–	–
Others		61,135	–	–	61,135	–	–	–
FINANCIAL ASSETS		3,085,311	5,000	2,616,788	388,727	8,624	66,172	–
Certificates of Indebtedness	21	327,372	–	–	–	–	–	327,372
Government-issued currency notes and coins in circulation	21	10,575	–	–	–	–	–	10,575
Balance of the banking system	22	164,093	–	–	–	–	–	164,093
Placements by banks and other financial institutions	23	50,734	–	–	–	–	–	50,734
Placements by Fiscal Reserves	24	773,862	–	–	–	–	–	773,862
Placements by HKSAR government funds and statutory bodies	25	214,911	–	–	–	–	–	214,911
Exchange Fund Bills and Notes issued	26	782,605	–	782,605	–	–	–	–
Derivative financial instruments	12(a)	4,347	4,347	–	–	–	–	–
Bank loans	27	9,525	–	–	–	–	–	9,525
Other debt securities issued	29	31,335	–	325	–	–	–	31,010
Others		74,362	–	–	–	–	–	74,362
FINANCIAL LIABILITIES		2,443,721	4,347	782,930	–	–	–	1,656,444

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

		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	7	51,353	–	–	51,353	–	–	–
Placements with banks and other financial institutions	8	148,042	–	–	148,042	–	–	–
Financial assets designated at fair value	10	2,492,917	–	2,492,917	–	–	–	–
Available-for-sale securities	11	43,608	–	–	–	–	43,608	–
Derivative financial instruments	12(a)	6,175	6,175	–	–	–	–	–
Held-to-maturity securities	13	9,324	–	–	–	9,324	–	–
Loan portfolio	14	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	21	289,837	–	–	–	–	–	289,837
Government-issued currency notes and coins in circulation	21	9,934	–	–	–	–	–	9,934
Balance of the banking system	22	255,851	–	–	–	–	–	255,851
Placements by Fiscal Reserves	24	717,536	–	–	–	–	–	717,536
Placements by HKSAR government funds and statutory bodies	25	167,913	–	–	–	–	–	167,913
Exchange Fund Bills and Notes issued	26	688,214	–	688,214	–	–	–	–
Derivative financial instruments	12(a)	2,593	2,593	–	–	–	–	–
Bank loans	27	9,250	–	–	–	–	–	9,250
Mortgage-backed securities issued	28	214	–	–	–	–	–	214
Other debt securities issued	29	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.)

	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 – 2013						
Cash and money at call	7	127,739	–	–	127,739	–	–	–
Placements with banks and other financial institutions	8	165,080	–	–	165,080	–	–	–
Financial assets designated at fair value	10	2,603,501	–	2,603,501	–	–	–	–
Available-for-sale securities	11	493	–	–	–	–	493	–
Derivative financial instruments	12(a)	3,492	3,492	–	–	–	–	–
Others		60,207	–	–	60,207	–	–	–
FINANCIAL ASSETS		2,960,512	3,492	2,603,501	353,026	–	493	–
Certificates of Indebtedness	21	327,372	–	–	–	–	–	327,372
Government-issued currency notes and coins in circulation	21	10,575	–	–	–	–	–	10,575
Balance of the banking system	22	164,093	–	–	–	–	–	164,093
Placements by banks and other financial institutions	23	50,734	–	–	–	–	–	50,734
Placements by Fiscal Reserves	24	773,862	–	–	–	–	–	773,862
Placements by HKSAR government funds and statutory bodies	25	214,911	–	–	–	–	–	214,911
Exchange Fund Bills and Notes issued	26	782,605	–	782,605	–	–	–	–
Derivative financial instruments	12(a)	3,124	3,124	–	–	–	–	–
Others		67,940	–	–	–	–	–	67,940
FINANCIAL LIABILITIES		2,395,216	3,124	782,605	–	–	–	1,609,487

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

		Fund – 2012						
	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	7	49,978	–	–	49,978	–	–	–
Placements with banks and other financial institutions	8	138,332	–	–	138,332	–	–	–
Financial assets designated at fair value	10	2,479,796	–	2,479,796	–	–	–	–
Available-for-sale securities	11	493	–	–	–	–	493	–
Derivative financial instruments	12(a)	4,429	4,429	–	–	–	–	–
Others		48,311	–	–	48,311	–	–	–
FINANCIAL ASSETS		2,721,339	4,429	2,479,796	236,621	–	493	–
Certificates of Indebtedness	21	289,837	–	–	–	–	–	289,837
Government-issued currency notes and coins in circulation	21	9,934	–	–	–	–	–	9,934
Balance of the banking system	22	255,851	–	–	–	–	–	255,851
Placements by Fiscal Reserves	24	717,536	–	–	–	–	–	717,536
Placements by HKSAR government funds and statutory bodies	25	167,913	–	–	–	–	–	167,913
Exchange Fund Bills and Notes issued	26	688,484	–	688,484	–	–	–	–
Derivative financial instruments	12(a)	1,652	1,652	–	–	–	–	–
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.)

7 CASH AND MONEY AT CALL

	Group		Fund	
	2013	2012	**2013**	2012
At amortised cost				
Balance with central banks	**53,004**	852	**53,004**	852
Balance with banks	**75,688**	50,501	**74,735**	49,126
TOTAL	**128,692**	51,353	**127,739**	49,978

8 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Fund	
	2013	2012	**2013**	2012
At amortised cost				
Placements in respect of reverse repurchase agreements:				
– with central banks	**38,794**	38,782	**38,794**	38,782
– with banks and other financial institutions	**8,018**	8,461	**8,018**	8,461
Other placements with banks	**129,820**	100,799	**118,268**	91,089
TOTAL	**176,632**	148,042	**165,080**	138,332

9 ASSETS HELD FOR SALE

The assets and liabilities related to the Group's 90% interest in Bauhinia HKMC Corporation Limited were classified as held for sale. The corresponding assets and liabilities amounted to HK$130 million and HK$0.4 million respectively as at 31 December 2013. The Group completed the sale of all its equity interest in January 2014.

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

10 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Fund	
	2013	2012	**2013**	2012
At fair value				
Debt securities				
Treasury bills and commercial paper				
Listed outside Hong Kong	**2,325**	4,649	**2,325**	4,649
Unlisted	**1,075,359**	775,424	**1,075,359**	775,424
Certificates of deposit				
Unlisted	**48,846**	35,729	**48,846**	35,729
Other debt securities				
Listed outside Hong Kong	**742,967**	598,138	**742,455**	596,294
Unlisted	**221,768**	646,186	**211,039**	636,439
Total debt securities	**2,091,265**	2,060,126	**2,080,024**	2,048,535
Equity securities				
Listed in Hong Kong	**152,895**	147,971	**152,895**	147,971
Listed outside Hong Kong	**297,317**	218,404	**297,317**	218,404
Unlisted	**75,311**	66,416	**73,265**	64,886
Total equity securities	**525,523**	432,791	**523,477**	431,261
TOTAL	**2,616,788**	2,492,917	**2,603,501**	2,479,796

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

11 AVAILABLE-FOR-SALE SECURITIES

	Group		Fund	
	2013	2012	**2013**	2012
Debt securities, at fair value				
Listed in Hong Kong	**379**	–	**–**	–
Listed outside Hong Kong	**192**	334	**–**	–
Unlisted	**2,371**	1,890	**–**	–
	2,942	2,224	**–**	–
Equity securities				
Listed in Hong Kong, at fair value	**918**	3,318	**–**	–
Unlisted, at cost	**493**	493	**493**	493
	1,411	3,811	**493**	493
Investment funds, at fair value				
Unlisted	**61,819**	37,573	**–**	–
TOTAL	**66,172**	43,608	**493**	493

The Group's investment in unlisted equity securities as at 31 December 2013 represents a holding of 4,285 shares (2012: 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 36). Investment in unlisted investment funds mainly represents the Group's holding of private equity funds under the Long-Term Growth Portfolio.

12 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, currency and bond options contracts, and equity 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 38.

(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			
	2013		2012		**2013**		2012	
	Assets	**Liabilities**	Assets	Liabilities	**Assets**	**Liabilities**	Assets	Liabilities
Derivatives categorised as trading financial instruments								
Interest rate derivatives								
Interest rate swap contracts	**580**	**970**	1,886	771	**554**	**531**	1,832	–
Interest rate futures contracts	**1**	**1**	–	–	**1**	**1**	–	–
Equity derivatives								
Equity contracts	**677**	**–**	303	–	**–**	**–**	–	–
Equity index futures contracts	**92**	**224**	110	554	**92**	**224**	110	554
Equity index option contracts	**–**	**–**	43	12	**–**	**–**	43	12
Currency derivatives								
Forward foreign exchange contracts	**2,846**	**2,365**	2,454	1,083	**2,835**	**2,365**	2,435	1,083
Bond futures contracts	**10**	**3**	9	3	**10**	**3**	9	3
	4,206	**3,563**	4,805	2,423	**3,492**	**3,124**	4,429	1,652
Derivatives designated as hedging instruments in fair value hedges								
Interest rate derivatives								
Interest rate swap contracts	**632**	**24**	1,227	–	**–**	**–**	–	–
Currency derivatives								
Currency swap contracts	**162**	**760**	143	170	**–**	**–**	–	–
	794	**784**	1,370	170	**–**	**–**	–	–
TOTAL	**5,000**	**4,347**	6,175	2,593	**3,492**	**3,124**	4,429	1,652

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									
	2013					2012				
	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	**35,880**	**300**	**1,943**	**15,756**	**17,881**	27,363	1,013	1,004	9,614	15,732
Interest rate futures contracts	**7,068**	**-**	**1,448**	**5,620**	**-**	999	-	-	999	-
Equity derivatives										
Equity contracts	**1,068**	**-**	**-**	**1,068**	**-**	1,022	-	-	1,022	-
Equity index futures contracts	**79,951**	**79,951**	**-**	**-**	**-**	41,380	41,380	-	-	-
Equity index option contracts	**-**	**-**	**-**	**-**	**-**	8,973	8,973	-	-	-
Currency derivatives										
Forward foreign exchange contracts	**306,029**	**300,962**	**2,159**	**2,908**	**-**	168,477	158,593	1,897	7,987	-
Bond futures contracts	**9,454**	**9,454**	**-**	**-**	**-**	9,799	9,799	-	-	-
	439,450	**390,667**	**5,550**	**25,352**	**17,881**	258,013	219,758	2,901	19,622	15,732
Derivatives designated as hedging instruments in fair value hedges										
Interest rate derivatives										
Interest rate swap contracts	**14,982**	**1,080**	**4,735**	**7,078**	**2,089**	16,786	1,532	2,123	9,966	3,165
Currency derivatives										
Currency swap contracts	**16,690**	**2,313**	**7,708**	**6,588**	**81**	17,465	1,826	6,582	9,057	-
	31,672	**3,393**	**12,443**	**13,666**	**2,170**	34,251	3,358	8,705	19,023	3,165
TOTAL	**471,122**	**394,060**	**17,993**	**39,018**	**20,051**	292,264	223,116	11,606	38,645	18,897

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

	Fund									
	Notional amounts with remaining life of									
	2013					2012				
	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	**23,790**	**–**	**1,000**	**8,390**	**14,400**	14,532	–	1,000	1,132	12,400
Interest rate futures contracts	**7,068**	**–**	**1,448**	**5,620**	**–**	999	–	–	999	–
Equity derivatives										
Equity index futures contracts	**79,951**	**79,951**	**–**	**–**	**–**	41,380	41,380	–	–	–
Equity index option contracts	**–**	**–**	**–**	**–**	**–**	8,973	8,973	–	–	–
Currency derivatives										
Forward foreign exchange contracts	**304,113**	**299,740**	**2,012**	**2,361**	**–**	164,986	156,874	1,897	6,215	–
Bond futures contracts	**9,454**	**9,454**	**–**	**–**	**–**	9,799	9,799	–	–	–
TOTAL	**424,376**	**389,145**	**4,460**	**16,371**	**14,400**	240,669	217,026	2,897	8,346	12,400

13 HELD-TO-MATURITY SECURITIES

	Group		Fund	
	2013	2012	**2013**	2012
At amortised cost				
Debt securities				
Listed in Hong Kong	**2,740**	2,533	**–**	–
Listed outside Hong Kong	**2,916**	2,953	**–**	–
Unlisted	**2,968**	3,838	**–**	–
TOTAL	**8,624**	9,324	**–**	–

Fair value information of the above held-to-maturity securities is disclosed in note 39.2.

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

14 LOAN PORTFOLIO

	Group		Fund	
	2013	2012	**2013**	2012
Mortgage loans, at amortised cost	**21,455**	24,886	**–**	–
Non-mortgage loans, at amortised cost	**815**	1,013	**–**	–
Allowance for loan impairment	**(2)**	(4)	**–**	–
TOTAL	**22,268**	25,895	**–**	–

15 GOLD

	Group and Fund	
	2013	2012
Gold, at fair value		
66,798 ounces (2012: 66,798 ounces)	**622**	862

The fair value of gold is based on quoted price in an active market. It is classified under Level 1 of the fair value hierarchy.

16 OTHER ASSETS

	Group		Fund	
	2013	2012	**2013**	2012
Interest and dividends receivable	**6,920**	8,591	**6,556**	8,090
Unsettled sales and redemption of securities	**45,817**	36,442	**45,817**	36,442
Prepayments, receivables and other assets	**7,703**	3,526	**7,194**	3,138
Staff housing loans	**138**	179	**138**	179
Loan to the International Monetary Fund	**527**	483	**527**	483
Deferred tax assets	**63**	92	**–**	–
TOTAL	**61,168**	49,313	**60,232**	48,332

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

17 INTERESTS IN SUBSIDIARIES

	Fund	
	2013	2012
Unlisted shares, at cost	**2,145**	2,145
Loans to subsidiaries	**66,400**	53,554
TOTAL	**68,545**	55,699

The following is a list of the principal subsidiaries held directly by the Fund as at 31 December 2013:

Name of company	Place of incorporation and operation	Principal activities	Issued equity capital	Fund's interest in equity capital
Debt Capital Solutions Company Limited	Hong Kong	Investment holding	HK$1	100%
Drawbridge Investment Limited	Hong Kong	Investment holding	HK$1	100%
Eight Finance Investment Company Limited	Hong Kong	Investment holding	HK$1	100%
Hong Kong Note Printing Limited	Hong Kong	Banknote printing	HK$255,000,000	55%
Real Gate Investment Company Limited	Hong Kong	Investment properties holding	HK$1	100%
Real Horizon Investment Company Limited	Hong Kong	Investment properties holding	HK$1	100%
Real Summit Investment Company Limited	Hong Kong	Investment properties holding	HK$1	100%
Stratosphere Finance Company Limited	Hong Kong	Investment holding	HK$1	100%
The Hong Kong Mortgage Corporation Limited	Hong Kong	Investment in mortgages and loans, mortgage securitisation and guarantee	HK$2,000,000,000	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 5.16% and 11.02% of the Group's respective items.

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

18 INTERESTS IN ASSOCIATES AND JOINT VENTURES

	Group		Fund	
	2013	2012	**2013**	2012
Associates				
Unlisted shares, at cost	**–**	–	**–**	–
Share of net assets	**67**	57	**–**	–
	67	57	**–**	–
Joint ventures				
Unlisted shares, at cost	**–**	–	**–**	–
Share of net assets	**780**	97	**–**	–
	780	97	**–**	–
Due from joint ventures	**8,584**	5,088	**–**	–
	9,364	5,185	**–**	–
TOTAL	**9,431**	5,242	**–**	–

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% (2012: 50%) equity interest.

The Group holds investments in seven joint ventures, which are all incorporated outside Hong Kong. Principal activities of these joint ventures are the holding of overseas investment properties. At the end of 2013, the Group holds equity interest in these joint ventures ranging from 48% to 51%. Although the Group's equity interest in some of these joint ventures exceeds 50%, they are still categorised as joint ventures because important business decisions relating to these joint ventures are required to be made with the consent of all parties. At 31 December 2013, the aggregate interest in these joint ventures amounted to 0.30% of the Group's total assets.

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

The Group's aggregate information of joint ventures that are not individually material is summarised below:

	Group	
	2013	2012
Share of profit for the year	**678**	645
Share of other comprehensive income	**4**	(33)
Share of total comprehensive income	**682**	612
Aggregate carrying amount of interests in the joint ventures	**9,364**	5,185

The Group's share of commitments to joint ventures is shown below:

	Group	
	2013	2012
Commitments to contribute funds	**698**	88

19 INVESTMENT PROPERTIES

	Group		Fund	
	2013	2012	**2013**	2012
At fair value				
At 1 January	**16,380**	3,126	**–**	–
Additions	**–**	12,926	**–**	–
Change in fair value on revaluation	**816**	(133)	**–**	–
Exchange difference	**499**	461	**–**	–
At 31 December	**17,695**	16,380	**–**	–

(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	
	2013	2012	**2013**	2012
Held outside Hong Kong				
on freehold	**9,444**	8,908	**–**	–
on long-term lease (over 50 years)	**8,251**	7,472	**–**	–
TOTAL	**17,695**	16,380	**–**	–

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	
	2013	2012	**2013**	2012
Gross rental income	**1,007**	386	**–**	–
Direct expenses	**(90)**	(23)	**–**	–
Net rental income	**917**	363	**–**	–

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

	Group		Fund	
	2013	2012	**2013**	2012
Within one year	**997**	954	**–**	–
After one year but not later than five years	**3,936**	3,782	**–**	–
After five years but not later than ten years	**3,871**	4,029	**–**	–
After ten years but not later than fifteen years	**1,855**	2,411	**–**	–
After fifteen years but not later than twenty years	**38**	14	**–**	–
TOTAL	**10,697**	11,190	**–**	–

At 31 December 2013, investment properties with a fair value of HK$17,695 million (2012: HK$16,380 million) were pledged to secure general banking facilities granted to the Group (note 27).

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

19.1 Fair value measurement of investment properties

The Group's investment properties are revalued at the end of each financial year by independent professionally qualified valuers on an open market value basis. The valuers have valued such properties based on 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. For all properties, their current use equates to the highest and best use. There has been no change to the valuation technique during the year.

Under the income approach, fair value is estimated using assumptions regarding the benefits and liabilities of ownership over the asset's life including the terminal value. This method involves the projection of a series of cash flows on a real property interest. To this projected cash flow series, a market-derived discount rate is applied to establish the present value of the income stream associated with the asset. The significant unobservable inputs used in the income approach are the selection of discount rates (which ranged from 4.9% to 6.1%), net initial yields (which ranged from 5.15% to 5.41%) and terminal capitalisation rates (which ranged from 4.9% to 6.2%). Significant increases or decreases in any of those inputs in isolation would result in significantly lower or higher fair value measurements, respectively.

All of the Group's investment properties are classified under Level 3 of the fair value hierarchy. There were no transfers into or out of Level 3 during the year.

An analysis of the movement between opening and closing balances of Level 3 investment properties, measured at fair value using a valuation technique with significant unobservable inputs, is shown below:

	Group	Fund
	2013	2013
At 1 January	16,380	–
Change in fair value on revaluation recognised as "income from investment properties" in the income and expenditure account	816	–
Exchange difference recognised as "net exchange gain/(loss)" in the income and expenditure account	499	–
At 31 December	17,695	–
Net gains recognised in the income and expenditure account held at the balance sheet date	1,315	–

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

20 PROPERTY, PLANT AND EQUIPMENT

(a)

	Group			
	Premises	Plant and equipment	Computer software licences and system development costs	Total
Cost				
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
At 1 January 2013	**3,852**	**866**	**295**	**5,013**
Additions	**–**	**130**	**36**	**166**
Disposals	**–**	**(6)**	**–**	**(6)**
At 31 December 2013	**3,852**	**990**	**331**	**5,173**
Accumulated depreciation				
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
At 1 January 2013	**809**	**611**	**254**	**1,674**
Charge for the year	**88**	**74**	**10**	**172**
Written back on disposal	**–**	**(5)**	**–**	**(5)**
At 31 December 2013	**897**	**680**	**264**	**1,841**
Net book value				
At 31 December 2013	**2,955**	**310**	**67**	**3,332**
At 31 December 2012	3,043	255	41	3,339

(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 2012	3,843	295	279	4,417
Additions	–	43	16	59
At 31 December 2012	3,843	338	295	4,476
At 1 January 2013	**3,843**	**338**	**295**	**4,476**
Additions	**–**	**32**	**36**	**68**
Disposals	**–**	**(2)**	**–**	**(2)**
At 31 December 2013	**3,843**	**368**	**331**	**4,542**
Accumulated depreciation				
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
At 1 January 2013	**804**	**242**	**254**	**1,300**
Charge for the year	**88**	**32**	**10**	**130**
Written back on disposal	**–**	**(2)**	**–**	**(2)**
At 31 December 2013	**892**	**272**	**264**	**1,428**
Net book value				
At 31 December 2013	**2,951**	**96**	**67**	**3,114**
At 31 December 2012	3,039	96	41	3,176

(b) The net book value of premises comprises:

	Group		Fund	
	2013	2012	**2013**	2012
In Hong Kong				
Leasehold land and the building situated thereon (leasehold between 10 and 50 years)	**2,932**	3,020	**2,928**	3,016
Outside Hong Kong				
Freehold land and the building situated thereon	**23**	23	**23**	23
TOTAL	**2,955**	3,043	**2,951**	3,039

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

21 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	
	2013	2012	**2013**	2012
Carrying amount	**327,372**	289,837	**10,575**	9,934
Reconciliation with face value:				
Hong Kong dollar face value	**329,325**	291,675	**10,638**	9,997
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$42,221 million**	US$37,394 million	**US$1,364 million**	US$1,282 million
Market exchange rate for translation into Hong Kong dollars	**US$1=HK$7.75375**	US$1=HK$7.75085	**US$1=HK$7.75375**	US$1=HK$7.75085
Carrying amount	**327,372**	289,837	**10,575**	9,934

22 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.)

23 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group and Fund	
	2013	2012
At amortised cost		
Placements by central banks	**50,734**	–

24 PLACEMENTS BY FISCAL RESERVES

	Group and Fund	
	2013	2012
Placements with interest payable at a fixed rate determined annually		
General Revenue Account	**407,622**	373,533
Land Fund	**219,730**	209,267
Capital Works Reserve Fund	**102,467**	92,103
Civil Service Pension Reserve Fund	**27,029**	25,742
Disaster Relief Fund	**33**	6
Innovation and Technology Fund	**2,011**	2,589
Lotteries Fund	**11,173**	10,200
Capital Investment Fund	**1,929**	1,211
Loan Fund	**1,821**	2,608
	773,815	717,259
Placements with interest payable at market-based rates		
General Revenue Account	**47**	277
TOTAL	**773,862**	717,536

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 5.0% per annum for 2013 (2012: 5.6%).

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

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

	Group and Fund	
	2013	2012
Placements with interest payable at a fixed rate[1] determined annually		
Research Endowment Fund	**25,979**	25,538
Bond Fund	**97,303**	72,209
Housing Authority	**36,605**	34,862
West Kowloon Cultural District Authority	**14,412**	11,756
Trading Funds	**5,280**	5,028
Community Care Fund	**15,938**	5,454
Elite Athletes Development Fund	**6,595**	6,281
Samaritan Fund	**6,352**	6,050
Environment and Conservation Fund	**4,798**	–
	213,262	167,178
Placements with interest payable at market-based rates		
Deposit Protection Scheme Fund	**1,649**	735
TOTAL	**214,911**	167,913

[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 5.0% per annum for 2013 (2012: 5.6%).

26 EXCHANGE FUND BILLS AND NOTES ISSUED

	Group		Fund	
	2013	2012	**2013**	2012
At fair value				
Exchange Fund Bills and Notes issued				
Exchange Fund Bills	**715,712**	618,263	**715,712**	618,263
Exchange Fund Notes	**68,892**	72,721	**68,892**	72,721
	784,604	690,984	**784,604**	690,984
Exchange Fund Bills held	**(1,999)**	(2,770)	**(1,999)**	(2,500)
TOTAL	**782,605**	688,214	**782,605**	688,484

(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			
	2013		2012		2013		2012	
	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	618,273	68,700	586,113	69,300	618,273	68,700	586,113	69,300
Issuance	2,110,221	16,400	1,864,764	16,400	2,110,221	16,400	1,864,764	16,400
Redemption	(2,012,681)	(17,000)	(1,832,604)	(17,000)	(2,012,681)	(17,000)	(1,832,604)	(17,000)
Nominal value at 31 December	715,813	68,100	618,273	68,700	715,813	68,100	618,273	68,700
Long positions held by Financial Stability and Other Activities segment								
Nominal value at 31 December	(2,000)	–	(2,770)	–	(2,000)	–	(2,500)	–
Total nominal value	713,813	68,100	615,503	68,700	713,813	68,100	615,773	68,700
Carrying amount, at fair value	713,713	68,892	615,493	72,721	713,713	68,892	615,763	72,721
Difference	100	(792)	10	(4,021)	100	(792)	10	(4,021)

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

27 BANK LOANS

	Group		Fund	
	2013	2012	2013	2012
At amortised cost				
Bank loans repayable:				
After two years but not later than five years	6,248	6,120	–	–
After five years but not later than ten years	3,277	3,130	–	–
	9,525	9,250	–	–

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

28 MORTGAGE-BACKED SECURITIES ISSUED

	Group		Fund	
	2013	2012	**2013**	2012
At amortised cost				
Mortgage-backed securities issued	**–**	214	**–**	–

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	
	2013	2012	**2013**	2012
Total mortgage-backed securities issued				
Nominal value at 1 January	**214**	367	**–**	–
Redemption	**(214)**	(153)	**–**	–
Nominal value at 31 December	**–**	214	**–**	–
Carrying amount	**–**	214	**–**	–
Difference	**–**	–	**–**	–

All mortgage-backed securities were redeemed in March 2013.

29 OTHER DEBT SECURITIES ISSUED

	Group		Fund	
	2013	2012	**2013**	2012
Debt securities issued, carried at amortised cost	**2,225**	3,392	**–**	–
Debt securities issued, designated as hedged items under fair value hedge	**28,785**	32,633	**–**	–
Debt securities issued, designated at fair value	**325**	340	**–**	–
TOTAL	**31,335**	36,365	**–**	–

(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	
	2013	2012	**2013**	2012
Total debt securities issued				
Nominal value at 1 January	**35,229**	40,273	**–**	–
Issuance	**18,162**	19,098	**–**	–
Redemption	**(21,966)**	(24,149)	**–**	–
Foreign currency translation differences	**–**	7	**–**	–
Nominal value at 31 December	**31,425**	35,229	**–**	–
Carrying amount	**31,335**	36,365	**–**	–
Difference	**90**	(1,136)	**–**	–
Debt securities issued, designated at fair value				
Nominal value	**389**	389	**–**	–
Carrying amount, at fair value	**325**	340	**–**	–
Difference	**64**	49	**–**	–

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

30 OTHER LIABILITIES

	Group		Fund	
	2013	2012	**2013**	2012
Unsettled purchases of securities	**67,349**	25,407	**67,349**	25,407
Accrued charges and other liabilities	**6,990**	6,889	**508**	388
Interest payable	**420**	491	**177**	211
Tax payable	**155**	108	**–**	–
Deferred tax liabilities	**90**	149	**–**	–
TOTAL	**75,004**	33,044	**68,034**	26,006

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

31 EQUITY

	Group		Fund	
	2013	2012	**2013**	2012
Attributable to owner of the Fund				
Accumulated surplus				
At 1 January	**637,268**	575,968	**623,884**	567,914
Surplus for the year	**20,721**	61,300	**13,624**	55,970
At 31 December	**657,989**	637,268	**637,508**	623,884
Revaluation reserve				
At 1 January	**3,917**	1,744	**–**	–
Fair value changes on available-for-sale securities:				
– revaluation	**9,884**	2,259	**–**	–
– realisation on disposal	**(296)**	(38)	**–**	–
– tax effect	**55**	(53)	**–**	–
Fair value changes on cash flow hedges:				
– transferred to income and expenditure account	**4**	6	**–**	–
– tax effect	**(1)**	(1)	**–**	–
	9,646	2,173	**–**	–
At 31 December	**13,563**	3,917	**–**	–
Translation reserve				
At 1 January	**36**	42	**–**	–
Currency translation differences:				
– subsidiaries and joint ventures	**37**	1	**–**	–
– reserve released on disposal of a joint venture	**–**	(7)	**–**	–
	37	(6)	**–**	–
At 31 December	**73**	36	**–**	–
	671,625	641,221	**637,508**	623,884
Non-controlling interests				
At 1 January	**478**	282	**–**	–
Surplus for the year	**72**	39	**–**	–
Currency translation differences	**1**	–	**–**	–
Capital injection by non-controlling interests	**38**	167	**–**	–
Dividends paid to non-controlling interests	**(23)**	(10)	**–**	–
At 31 December	**566**	478	**–**	–
TOTAL	**672,191**	641,699	**637,508**	623,884

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

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

	Group		Fund	
	2013	2012	**2013**	2012
Cash and money at call	**128,692**	51,353	**127,739**	49,978
Placements with banks and other financial institutions	**165,042**	139,068	**163,529**	137,930
Treasury bills and commercial paper	**34,760**	117,392	**34,760**	117,392
TOTAL	**328,494**	307,813	**326,028**	305,300

Reconciliation with the balance sheet

		Group		Fund	
	Note	**2013**	2012	**2013**	2012
Amounts shown in the balance sheet					
Cash and money at call	7	**128,692**	51,353	**127,739**	49,978
Placements with banks and other financial institutions	8	**176,632**	148,042	**165,080**	138,332
Financial assets designated at fair value					
Treasury bills and commercial paper	10	**1,077,684**	780,073	**1,077,684**	780,073
		1,383,008	979,468	**1,370,503**	968,383
Less: Amounts with original maturity beyond 3 months		**(1,054,514)**	(671,655)	**(1,044,475)**	(663,083)
Cash and cash equivalents in the statement of cash flows		**328,494**	307,813	**326,028**	305,300

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

33 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 2.20.

	Group							
	Currency Board Operations (note 33(a))		Reserves Management		Financial Stability and Other Activities		Total	
	2013	2012	**2013**	2012	**2013**	2012	**2013**	2012
Income								
Interest and dividend income	**4,664**	4,708	**22,918**	22,196	**1,080**	1,316	**28,662**	28,220
Investment gains/(losses)	**(8,505)**	(523)	**51,386**	83,093	**362**	129	**43,243**	82,699
Other income	**–**	–	**42**	40	**681**	733	**723**	773
	(3,841)	4,185	**74,346**	105,329	**2,123**	2,178	**72,628**	111,692
Expenditure								
Interest expense	**1,251**	1,168	**46,468**	45,890	**255**	361	**47,974**	47,419
Other expenses	**922**	811	**1,455**	947	**2,055**	1,834	**4,432**	3,592
	2,173	1,979	**47,923**	46,837	**2,310**	2,195	**52,406**	51,011
Surplus/(Deficit) before share of profit of associates and joint ventures	**(6,014)**	2,206	**26,423**	58,492	**(187)**	(17)	**20,222**	60,681
Share of profit of associates and joint ventures, net of tax	**–**	–	**678**	642	**10**	12	**688**	654
Gain from disposal of a joint venture	**–**	–	**–**	–	**–**	7	**–**	7
Surplus/(Deficit) before taxation	**(6,014)**	2,206	**27,101**	59,134	**(177)**	2	**20,910**	61,342

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

	Group									
	Currency Board Operations (note 33(a))		Reserves Management		Financial Stability and Other Activities		Re-allocation (note 33(b) & (c))		Total	
	2013	2012	**2013**	2012	**2013**	2012	**2013**	2012	**2013**	2012
Assets										
Backing Assets										
Investment in designated US dollar assets	**1,372,916**	1,317,605	**–**	–	**–**	–	**–**	–	**1,372,916**	1,317,605
Interest receivable on designated US dollar assets	**1,176**	1,427	**–**	–	**–**	–	**–**	–	**1,176**	1,427
Net accounts receivable/(payable)	**(25,188)**	(3,487)	**–**	–	**–**	–	**25,188**	3,487	**–**	–
Other investments	**–**	–	**1,532,082**	1,416,972	**143,726**	61,816	**(1,800)**	(2,770)	**1,674,008**	1,476,018
Other assets	**–**	–	**24,172**	19,610	**10,995**	6,375	**33,287**	31,415	**68,454**	57,400
TOTAL ASSETS	**1,348,904**	1,315,545	**1,556,254**	1,436,582	**154,721**	68,191	**56,675**	32,132	**3,116,554**	2,852,450
Liabilities										
Monetary Base										
Certificates of Indebtedness	**327,372**	289,837	**–**	–	**–**	–	**–**	–	**327,372**	289,837
Government-issued currency notes and coins in circulation	**10,575**	9,934	**–**	–	**–**	–	**–**	–	**10,575**	9,934
Balance of the banking system	**164,093**	255,851	**–**	–	**–**	–	**–**	–	**164,093**	255,851
Exchange Fund Bills and Notes issued	**784,604**	690,984	**–**	–	**–**	–	**(1,999)**	(2,770)	**782,605**	688,214
Interest payable on Exchange Fund Notes	**177**	211	**–**	–	**–**	–	**–**	–	**177**	211
Net accounts (receivable)/payable	**(32,968)**	(31,415)	**–**	–	**–**	–	**33,486**	31,415	**518**	–
Mortgage-backed securities issued	**–**	–	**–**	–	**–**	214	**–**	–	**–**	214
Other debt securities issued	**–**	–	**–**	–	**31,335**	36,365	**–**	–	**31,335**	36,365
Placements by banks and other financial institutions	**–**	–	**–**	–	**50,734**	–	**–**	–	**50,734**	–
Bank loans	**–**	–	**9,525**	9,250	**–**	–	**–**	–	**9,525**	9,250
Placements by Fiscal Reserves	**–**	–	**773,862**	717,536	**–**	–	**–**	–	**773,862**	717,536
Placements by HKSAR government funds and statutory bodies	**–**	–	**213,262**	167,178	**1,649**	735	**–**	–	**214,911**	167,913
Other liabilities	**–**	–	**40,343**	25,035	**13,125**	6,904	**25,188**	3,487	**78,656**	35,426
TOTAL LIABILITIES	**1,253,853**	1,215,402	**1,036,992**	918,999	**96,843**	44,218	**56,675**	32,132	**2,444,363**	2,210,751

(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 107.41% as at 31 December 2013 (2012: 108.07%).

(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 2013, deductions from the Backing Assets comprised "other liabilities" of HK$25,188 million (2012: HK$3,487 million).

The Monetary Base is also presented on a net basis. As at 31 December 2013, deductions from the Monetary Base comprising "other assets" of HK$33,486 million (2012: HK$31,415 million) consisted of three 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$21 million (2012: HK$29 million) and unrealised gains of HK$516 million (2012: HK$1,803 million) on these interest rate swaps are included in "net accounts (receivable)/payable" to reduce the Monetary Base.

– When Hong Kong dollar overnight advances secured on EFBN have been made to banks under the Discount Window Operations, the advances of HK$199 million (2012: Nil) are included in "net accounts (receivable)/payable" to reduce the Monetary Base.

– EFBN issued on tender date but not yet settled of HK$32,750 million (2012: HK$29,583 million) 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.)

34 PLEDGED ASSETS

Assets are pledged as margin for equity index contracts, bond futures contracts and securities lending agreements, as security 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	**2013**	2012	**2013**	2012
Secured liabilities					
Equity index futures contracts, at fair value	12(a)	**132**	444	**132**	444
Interest rate swap, at fair value		**4**	–	**4**	–
Bank loans	27	**9,525**	9,250	**–**	–
Mortgage-backed securities issued	28	**–**	214	**–**	–
Assets pledged					
Cash and money at call		**2**	–	**2**	–
Financial assets designated at fair value		**6,327**	4,726	**6,327**	4,726
Investment properties		**17,695**	16,380	**–**	–
Mortgage loans		**–**	210	**–**	–

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.)

35 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	
	2013	2012	**2013**	2012
Contracted for	**14**	38	**9**	34
Authorised but not yet contracted for	**275**	276	**253**	168
	289	314	**262**	202

(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 2013, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK$4,060 million equivalent (2012: HK$4,050 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$527 million equivalent with a repayment term of five years (2012: HK$483 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 (2012: 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 2013, there was no outstanding balance due from the HKDPB under this facility (2012: 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 (2012: HK$30 billion) at prevailing market interest rates. As at 31 December 2013, there was no outstanding balance due from the HKMC under this facility (2012: 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$44,584 million equivalent (2012: HK$44,567 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2013, there was no outstanding transaction with any central bank under this arrangement (2012: 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 2013, 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. The bilateral swap outstanding as at 31 December 2013 was RMB40 billion (2012: Nil).

(h) Investment commitments

The Group's subsidiaries with principal activities of holding investment, including properties, had outstanding investment commitment of HK$80,211 million equivalent as at 31 December 2013 (2012: HK$63,813 million equivalent).

(i) Lease commitments

As at 31 December 2013, the total future minimum lease payments payable under non-cancellable operating leases of premises were as follows:

	Group		Fund	
	2013	2012	**2013**	2012
Within one year	**90**	57	**59**	43
After one year but not later than five years	**211**	141	**158**	128
Later than five years	**16**	–	**16**	–
TOTAL	**317**	198	**233**	171

(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 and operating costs of the Financial Dispute Resolution Centre Limited (FDRCL) for its 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$4 million to FDRCL (2012: HK$14 million). The outstanding commitment of the Fund to contribute to FDRCL as at 31 December 2013 was HK$14 million (2012: HK$28 million).

36 CONTINGENT LIABILITIES

As at 31 December 2013, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK$192 million equivalent (2012: 16.1 million Special Drawing Rights or HK$191 million equivalent), in respect of the uncalled portion of its 4,285 shares (2012: 4,285 shares) in the Bank for International Settlements (note 11).

37 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$151 million (2012: HK$127 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.

38 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.

38.1 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.)

38.2 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:

	2013	2012
Asset type		
Bonds	**74%**	75%
Equities and related investments	**26%**	25%
	100%	100%
Currency		
US dollar and Hong Kong dollar	**77%**	79%
Others[1]	**23%**	21%
	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 of 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.

38.3 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.

38.3.1 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 sovereign risk and the transfer risk. Sovereign risk denotes a government's ability and willingness to repay its obligations. Transfer risk is the risk that a borrower may not be able to secure foreign exchange to service its external obligations, for example, due to an action by the government to impose restrictions on the transfer of funds from the debtors in the country to foreign creditors. Under the existing framework, country limits are established to control the Fund's overall credit risk exposures to the countries endorsed by the CRCC.

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.)

38.3.2 Exposure to credit risk

The maximum exposure to credit risk of the financial assets of the Group and the Fund are equal to their carrying amounts. The maximum exposures to credit risk of off-balance sheet exposures are as follows:

		Group		Fund	
	Note	**2013**	2012	**2013**	2012
Risk in force – mortgage insurance	38.6	**14,454**	16,615	**–**	–
Risk in force – other guarantees and insurance	38.6	**1,625**	1,152	**–**	–
Loan commitments and other credit related commitments		**280,908**	264,533	**230,697**	230,720
TOTAL		**296,987**	282,300	**230,697**	230,720

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

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

38.3.3 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 2013, approximately 91% (2012: 90%) 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	
	2013	2012	**2013**	2012
Cash and money at call, placements with banks and other financial institutions, by credit rating[1]				
AAA	**273**	708	**273**	708
AA- to AA+	**104,560**	109,257	**100,677**	108,360
A- to A+	**144,704**	85,346	**137,188**	76,273
Lower than A- or un-rated[2]	**55,787**	4,084	**54,681**	2,969
	305,324	199,395	**292,819**	188,310
Debt securities, by credit rating[1]				
AAA	**401,188**	493,163	**398,614**	490,040
AA- to AA+	**1,513,665**	1,361,834	**1,506,633**	1,355,254
A- to A+	**50,106**	46,202	**48,146**	44,356
Lower than A- or un-rated[2]	**137,872**	170,475	**126,631**	158,885
	2,102,831	2,071,674	**2,080,024**	2,048,535
Loan portfolio				
Neither past due nor impaired (note 38.3.3(a))	**21,969**	25,518	**–**	–
Past due but not impaired (note 38.3.3(b))	**299**	379	**–**	–
Impaired (note 38.3.3(c))	**2**	2	**–**	–
Allowance for loan impairment	**(2)**	(4)	**–**	–
	22,268	25,895	**–**	–
TOTAL	**2,430,423**	2,296,964	**2,372,843**	2,236,845

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 further credit enhancements in addition to 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	
	2013	2012	**2013**	2012
Grades				
1 to 3	**21,950**	25,500	**–**	–
4	**–**	–	**–**	–
5	**19**	18	**–**	–
TOTAL	**21,969**	25,518	**–**	–

(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	
	2013	2012	**2013**	2012
Loans that were past due				
90 days or less	**297**	376	**–**	–
91 to 180 days	**–**	–	**–**	–
over 180 days	**2**	3	**–**	–
TOTAL	**299**	379	**–**	–
Fair value of collateral and other credit enhancements	**2,156**	2,531	**–**	–

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

(c) Impaired loans

These are loans where the Group determines on an individual basis that it is probable that it will be unable to collect all principal and interest due according to the contractual terms of the loan agreements. As at 31 December 2013, the fair value of related collateral held and credit enhancement was HK$4 million (2012: HK$8 million).

(d) Repossessed collateral

The Group obtained assets by taking possession of collateral held as security. Repossessed properties are sold as soon as practicable, with the proceeds used to reduce the outstanding indebtedness. As at 31 December 2013, repossessed properties of the Group amounted to HK$2 million (2012: HK$2 million).

38.3.4 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	
	2013	2012	**2013**	2012
Governments and government agencies[1]	**1,882,464**	1,755,383	**1,881,476**	1,754,458
Supra-nationals	**143,575**	171,433	**143,564**	171,411
States, provinces and public-sector entities[2]	**188,729**	176,283	**217,964**	204,720
Financial institutions	**282,407**	221,984	**262,969**	203,944
Others[3]	**304,954**	314,566	**227,666**	239,326
TOTAL	**2,802,129**	2,639,649	**2,733,639**	2,573,859

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.

38.4 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.

38.4.1 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 or 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.

38.4.2 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 a 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 (i.e. private equity and real estate) 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 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.)

38.4.3 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 – 2013 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	76,884	-	-	-	-	-	76,884	51,808
Placements with banks and other financial institutions	157,219	12,234	7,160	-	-	-	176,613	19
Financial assets designated at fair value	370,298	459,236	523,917	416,935	206,131	96,888	2,073,405	543,383
Available-for-sale securities	217	571	1,215	939	-	-	2,942	63,230
Held-to-maturity securities	295	420	1,589	2,619	3,701	-	8,624	-
Loan portfolio	18,603	3,604	23	36	2	-	22,268	-
Interest-bearing assets	623,516	476,065	533,904	420,529	209,834	96,888	2,360,736	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	50,734
Placements by Fiscal Reserves with interest payable at market-based rates[1]	47	-	-	-	-	-	47	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates[1]	1,649	-	-	-	-	-	1,649	-
Exchange Fund Bills and Notes issued	200,841	323,698	205,106	37,260	9,871	5,829	782,605	-
Bank loans	9,525	-	-	-	-	-	9,525	-
Other debt securities issued	4,910	9,767	4,802	9,329	2,527	-	31,335	-
Interest-bearing liabilities	216,972	333,465	209,908	46,589	12,398	5,829	825,161	
Net interest-bearing assets/(liabilities)	406,544	142,600	323,996	373,940	197,436	91,059	1,535,575	
Interest rate derivatives (net position, notional amounts)	3,972	(27,183)	5,733	3,532	7,374	6,000	(572)	
Interest rate sensitivity gap	410,516	115,417	329,729	377,472	204,810	97,059	1,535,003	

[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 24 and 25). The fixed rate is determined every January. As at 31 December 2013, such placements amounted to HK$987,077 million (2012: HK$884,437 million).

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

	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 24 and 25). The fixed rate is determined every January. As at 31 December 2013, such placements amounted to HK$987,077 million (2012: HK$884,437 million).

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

	Fund – 2013							
	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	76,418	-	-	-	-	-	76,418	51,321
Placements with banks and other financial institutions	153,905	11,175	-	-	-	-	165,080	-
Financial assets designated at fair value	369,916	459,010	523,794	416,485	206,070	96,888	2,072,163	531,338
Interest-bearing assets	600,239	470,185	523,794	416,485	206,070	96,888	2,313,661	
Liabilities								
Placements by banks and other financial institutions	-	-	-	-	-	-	-	50,734
Placements by Fiscal Reserves with interest payable at market-based rates[1]	47	-	-	-	-	-	47	-
Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates[1]	1,649	-	-	-	-	-	1,649	-
Exchange Fund Bills and Notes issued	200,841	323,698	205,106	37,260	9,871	5,829	782,605	-
Interest-bearing liabilities	202,537	323,698	205,106	37,260	9,871	5,829	784,301	
Net interest-bearing assets/(liabilities)	397,702	146,487	318,688	379,225	196,199	91,059	1,529,360	
Interest rate derivatives (net position, notional amounts)	-	(16,200)	1,000	800	8,400	6,000	-	
Interest rate sensitivity gap	397,702	130,287	319,688	380,025	204,599	97,059	1,529,360	

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 24 and 25). The fixed rate is determined every January. As at 31 December 2013, such placements amounted to HK$987,077 million (2012: HK$884,437 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 24 and 25). The fixed rate is determined every January. As at 31 December 2013, such placements amounted to HK$987,077 million (2012: HK$884,437 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			
	2013		2012	
	Assets (in HK$ billion)	**Liabilities (in HK$ billion)**	Assets (in HK$ billion)	Liabilities (in HK$ billion)
Hong Kong dollar	**311.0**	**2,013.3**	228.4	1,854.5
US dollar	**2,281.8**	**408.8**	2,143.1	334.6
	2,592.8	**2,422.1**	2,371.5	2,189.1
Others[1]	**523.8**	**22.3**	481.0	21.7
TOTAL	**3,116.6**	**2,444.4**	2,852.5	2,210.8

	Fund			
	2013		2012	
	Assets (in HK$ billion)	**Liabilities (in HK$ billion)**	Assets (in HK$ billion)	Liabilities (in HK$ billion)
Hong Kong dollar	**278.6**	**1,992.1**	193.3	1,830.3
US dollar	**2,250.0**	**400.1**	2,122.1	323.6
	2,528.6	**2,392.2**	2,315.4	2,153.9
Others[1]	**504.2**	**3.1**	465.7	3.3
TOTAL	**3,032.8**	**2,395.3**	2,781.1	2,157.2

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

(c) Equity price risk

As at 31 December 2013 and 2012, the majority of equity investments were reported as "financial assets designated at fair value" as shown in note 10.

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

38.4.4 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	
	2013	2012
Value-at-Risk		
At 31 December[1]	**26,736**	21,059
During the year		
Average	**29,431**	29,811
Maximum	**47,008**	39,827
Minimum	**20,523**	21,059

[1] The amount represented 0.9% of the Fund's investments which were subject to VaR measurement as at 31 December 2013 (2012: 0.8%).

38.5 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.

38.5.1 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.)

38.5.2 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 – 2013 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	327,372	–	–	–	–	–	327,372
Government-issued currency notes and coins in circulation	10,575	–	–	–	–	–	10,575
Balance of the banking system	164,093	–	–	–	–	–	164,093
Placements by banks and other financial institutions	50,734	–	–	–	–	–	50,734
Placements by Fiscal Reserves	773,862	–	–	–	–	–	773,862
Placements by HKSAR government funds and statutory bodies	112,261	–	–	84,150	18,500	–	214,911
Exchange Fund Bills and Notes issued	200,841	323,938	205,893	38,818	11,057	6,329	786,876
Bank loans	107	–	317	7,569	3,378	–	11,371
Other debt securities issued	1,618	2,392	10,961	15,330	2,653	–	32,954
Other liabilities	73,384	381	8	–	169	–	73,942
Loan commitments and other credit related commitments	280,908	–	–	–	–	–	280,908
TOTAL	1,995,755	326,711	217,179	145,867	35,757	6,329	2,727,598
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
– on net basis	227	(27)	(74)	30	614	175	945
– on gross basis							
Total outflows	139,315	30,062	9,237	8,001	87	–	186,702
Total inflows	(137,470)	(29,692)	(9,338)	(7,400)	(106)	–	(184,006)
TOTAL	2,072	343	(175)	631	595	175	3,641

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

	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.)

	Fund – 2013 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	327,372	–	–	–	–	–	327,372
Government-issued currency notes and coins in circulation	10,575	–	–	–	–	–	10,575
Balance of the banking system	164,093	–	–	–	–	–	164,093
Placements by banks and other financial institutions	50,734	–	–	–	–	–	50,734
Placements by Fiscal Reserves	773,862	–	–	–	–	–	773,862
Placements by HKSAR government funds and statutory bodies	112,261	–	–	84,150	18,500	–	214,911
Exchange Fund Bills and Notes issued	200,841	323,938	205,893	38,818	11,057	6,329	786,876
Other liabilities	67,376	379	8	–	–	–	67,763
Loan commitments and other credit related commitments	230,697	–	–	–	–	–	230,697
TOTAL	1,937,811	324,317	205,901	122,968	29,557	6,329	2,626,883
Derivative cash (inflows)/outflows							
Derivative financial instruments settled:							
– on net basis	228	(29)	(69)	17	603	175	925
– on gross basis							
Total outflows	137,102	28,498	1,039	1,213	–	–	167,852
Total inflows	(135,215)	(28,103)	(979)	(1,159)	–	–	(165,456)
TOTAL	2,115	366	(9)	71	603	175	3,321

(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

38.6 Insurance risk

The Group provides (i) mortgage insurance cover to authorized institutions in respect of mortgage loans originated by such authorized institutions and secured on residential properties in Hong Kong; (ii) insurance cover to authorized institutions in respect of reverse mortgage loans originated by such authorized institutions to elderly people; (iii) financial guarantee cover to authorized institutions in respect of loans originated by such authorized institutions to small and medium sized enterprises (SMEs) in Hong Kong. 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 2013, the total risk-in-force was HK$14.5 billion (2012: HK$16.6 billion), of which HK$12 billion (2012: HK$13.8 billion) was retained by the Group after reinsurance. The Group also provides financial guarantee cover to authorized institutions up to 50% to 70% of the banking facilities granted to SMEs in Hong Kong and insurance cover to authorized institutions in respect of reverse mortgage loans originated by such authorized institutions and secured on residential properties. As at 31 December 2013, the total risk-in-force was HK$1.6 billion (2012: HK$1.2 billion).

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. Insurance events are random and 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 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, a slump in local property market and a low mortality rate of borrowers. Economic downturn, which may cause a rise in defaulted payment, affects the frequency of claims and collateral value. A drop in property prices, where the collateral values fall below the outstanding balance of the mortgage loans, will increase the severity of claims. Low mortality rate of borrowers means longer payout period and larger loan balance over time. This will affect the frequency and severity of claims as there is a risk of the property value being insufficient to cover the outstanding loan balance in the future.

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 arrangements in an effort to limit its risk exposure. The reinsurers are selected according to prudent criteria and their credit ratings are reviewed regularly. For financial guarantee cover provided to authorized institutions, the Group relies on the lenders' prudent credit assessment on the borrowers to mitigate default risk and any loss in the loan facility will be shared proportionately between the Group and the lender on a pari passu basis to minimise moral hazards. The mortality assumptions of reverse mortgages are also reviewed on a regular basis, to assess the risk of larger deviation between the actual and expected operating results.

38.7 Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk is inherent in all aspects of the Group's operations covering all business segments.

The Group's objective is to manage operational risk cost-effectively to prevent financial losses or damage to the Group's reputation.

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 with the three Deputy Chief Executives as members. The Risk Committee provides direction and guidance for line management in managing operational risk.

Operational risk management is supported by a formal risk assessment process. This is conducted annually and requires each division to assess and rank the potential impact and likelihood of occurrence of financial and operational risks. It also requires divisions to review the procedures and controls in place for addressing the identified risks. This risk and control self-assessment is reviewed by Internal Audit to ensure consistency and reasonableness before submission to the Risk Committee, which has the responsibility for ensuring that the identified risks are properly addressed. Results of this risk assessment also form the basis for the development of an annual Internal Audit work plan. Internal Audit will audit the risk areas at various frequencies depending on the levels of risks and the results of past audits. It reports its findings regularly to the EFAC Audit Sub-Committee and the Chief Executive of the HKMA and follows up on outstanding issues to ensure that they are resolved in a proper manner.

Operational risk is also inherent in the investment activities and processes of the Reserves Management Department. To enhance its operational risk oversight, the RMC Division formalised its operational risk management framework for the Reserves Management Department in 2013. The key elements of the framework include identification and monitoring of key risk indicators; reporting to the senior management of the HKMA on the operational risk profile of the Reserves Management Department; and handling of operational risk incidents.

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

39 FAIR VALUE MEASUREMENT OF FINANCIAL INSTRUMENTS

39.1 Fair value of financial instruments measured at fair value on a recurring basis

39.1.1 Fair value hierarchy

The carrying values of financial instruments measured at fair value at the balance sheet date across the three levels of the fair value hierarchy are shown below:

	Group – 2013			
	Level 1	Level 2	Level 3	Total
Assets				
Financial assets designated at fair value				
Treasury bills and commercial paper	694,890	382,794	–	1,077,684
Certificates of deposit	–	48,846	–	48,846
Debt securities	908,289	46,256	10,190	964,735
Equity securities	450,699	50,899	23,925	525,523
	2,053,878	528,795	34,115	2,616,788
Available-for-sale securities				
Debt securities	1,228	1,714	–	2,942
Equity securities	918	–	–	918
Investment funds	–	–	61,819	61,819
	2,146	1,714	61,819	65,679
Derivative financial instruments	103	4,220	677	5,000
	2,056,127	534,729	96,611	2,687,467
Liabilities				
Exchange Fund Bills and Notes issued	–	782,605	–	782,605
Derivative financial instruments	228	4,119	–	4,347
Other debt securities issued, designated at fair value	–	325	–	325
	228	787,049	–	787,277

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

	Group – 2012			
	Level 1	Level 2	Level 3	Total
Assets				
Financial assets designated at fair value				
Treasury bills and commercial paper	360,717	419,356	–	780,073
Certificates of deposit	35,729	–	–	35,729
Debt securities	1,189,279	47,158	7,887	1,244,324
Equity securities	366,701	46,146	19,944	432,791
	1,952,426	512,660	27,831	2,492,917
Available-for-sale securities				
Debt securities	654	1,571	–	2,225
Equity securities	3,318	–	–	3,318
Investment funds	–	–	37,572	37,572
	3,972	1,571	37,572	43,115
Derivative financial instruments	119	5,753	303	6,175
	1,956,517	519,984	65,706	2,542,207
Liabilities				
Exchange Fund Bills and Notes issued	–	688,214	–	688,214
Derivative financial instruments	557	2,036	–	2,593
Other debt securities issued, designated at fair value	–	340	–	340
	557	690,590	–	691,147

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

	Fund – 2013			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Financial assets designated at fair value				
Treasury bills and commercial paper	**694,890**	**382,794**	**–**	**1,077,684**
Certificates of deposit	**–**	**48,846**	**–**	**48,846**
Debt securities	**908,289**	**45,205**	**–**	**953,494**
Equity securities	**450,699**	**50,899**	**21,879**	**523,477**
	2,053,878	**527,744**	**21,879**	**2,603,501**
Derivative financial instruments	**103**	**3,389**	**–**	**3,492**
	2,053,981	**531,133**	**21,879**	**2,606,993**
Liabilities				
Exchange Fund Bills and Notes issued	**–**	**782,605**	**–**	**782,605**
Derivative financial instruments	**228**	**2,896**	**–**	**3,124**
	228	**785,501**	**–**	**785,729**

	Fund – 2012			
	Level 1	Level 2	Level 3	Total
Assets				
Financial assets designated at fair value				
Treasury bills and commercial paper	360,717	419,356	–	780,073
Certificates of deposit	35,729	–	–	35,729
Debt securities	1,189,279	43,454	–	1,232,733
Equity securities	366,701	46,146	18,414	431,261
	1,952,426	508,956	18,414	2,479,796
Derivative financial instruments	119	4,310	–	4,429
	1,952,545	513,266	18,414	2,484,225
Liabilities				
Exchange Fund Bills and Notes issued	–	688,484	–	688,484
Derivative financial instruments	557	1,095	–	1,652
	557	689,579	–	690,136

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 assets, measured at fair value using a valuation technique with significant unobservable inputs, is shown below:

	Group					
	Designated at fair value		Available-for-sale		Derivatives	
	2013	2012	**2013**	2012	**2013**	2012
At 1 January	**27,831**	21,987	**37,572**	20,668	**303**	–
Net gains recognised in the income and expenditure account	**3,584**	3,143	**112**	19	**374**	303
Net gains recognised in other comprehensive income	**–**	–	**9,922**	1,901	**–**	–
Purchases	**10,217**	11,667	**17,274**	17,246	**–**	–
Sales	**(7,585)**	(7,675)	**(3,061)**	(2,262)	**–**	–
Transfers into Level 3	**355**	576	**–**	–	**–**	–
Transfers out of Level 3	**(287)**	(1,867)	**–**	–	**–**	–
At 31 December	**34,115**	27,831	**61,819**	37,572	**677**	303
Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date	**3,868**	2,866	**–**	–	**374**	303

	Fund			
	Designated at fair value		Available-for-sale	
	2013	2012	**2013**	2012
At 1 January	**18,414**	16,509	**–**	–
Net gains recognised in the income and expenditure account	**2,079**	1,671	**–**	–
Purchases	**6,179**	7,257	**–**	–
Sales	**(4,888)**	(5,745)	**–**	–
Transfers into Level 3	**332**	539	**–**	–
Transfers out of Level 3	**(237)**	(1,817)	**–**	–
At 31 December	**21,879**	18,414	**–**	–
Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date	**2,353**	1,401	**–**	–

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.

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

39.1.2 Valuation techniques and key inputs

The fair value of financial instruments classified under Level 1 is based on quoted market prices in active markets for identical assets or liabilities at the balance sheet date.

In the absence of quoted market prices in active markets, the fair value of financial instruments classified under Level 2 is estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date. Specific valuation techniques and key inputs used to value these financial instruments include:

i) quoted market price or broker quotes for similar instruments;

ii) derivative financial instruments are priced using models with observable market inputs including interest rate swaps and foreign exchange contracts; and

iii) commercial paper and debt securities are priced using discount cash flows techniques with observable yield curves.

For investments in unlisted investment funds, certain unlisted equity securities, equity contracts and certain unlisted debt securities which are classified under Level 3, their fair values are estimated by making reference to valuation reports provided by investment managers. It is not practicable to quote a range of key unobservable inputs.

For certain unlisted equity securities and the associated equity contracts valued by the Group, which are classified under Level 3, their fair values are derived from Comparable Company Valuation Model, which derives the valuation of an investment through the product of its earnings, earning multiples of comparable public companies and a discount factor for a lack of liquidity. Significant unobservable inputs used under this valuation method include earning multiples of similar companies and liquidity discount:

Significant unobservable inputs	**Quantitative amount**
Earning multiples of similar companies	10.1 – 19.3
Liquidity discount	20%

If the prices of these investments had increased/decreased by 10%, it would have resulted in an increase/decrease in the Group's surplus for the year of HK$3,479 million (2012: HK$2,813 million) and in other comprehensive income of HK$6,182 million (2012: HK$3,757 million).

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

39.2 Fair value of debt securities not measured at fair value on a recurring basis

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	**2013**	2012	**2013**			2012
				Level 1	**Level 2**	**Total**	Total
Financial assets							
Held-to-maturity securities	13	**8,624**	9,324	**5,725**	**3,039**	**8,764**	9,836
Financial liabilities							
Mortgage-backed securities issued	28	**–**	214	**–**	**–**	**–**	214
Other debt securities issued	29	**31,010**	36,025	**–**	**31,011**	**31,011**	36,029

In the absence of quoted market prices in active markets, the fair values of debt securities classified under Level 2 are estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date. Specific valuation techniques and key inputs used to value these debt securities include quoted market prices for securities with similar credit, maturity and yield characteristics for held-to-maturity securities, discounted cash flow model based on a current yield curve appropriate for the remaining term to maturity for other debt securities issued.

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 2013 and 2012.

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

40 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2013

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 2013 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
HKFRS 9, Financial Instruments	Unspecified
Amendments to HKAS 32, Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities	1 January 2014
Amendments to HKAS 36, Impairment of Assets – Recoverable Amount Disclosures for Non-Financial Assets	1 January 2014
Amendments to HKAS 39, Financial Instruments: Recognition and Measurement – Novation of Derivatives and Continuation of Hedge Accounting	1 January 2014
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

41 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 4 April 2014.

Calendar of Events 2013

1 January	The first phase of the Basel III capital standards comes into operation.
18 January	The International Monetary Fund releases its Staff Report on Hong Kong, reiterating the Linked Exchange Rate system remains the best arrangement for Hong Kong and commending the Government's pre-emptive efforts to safeguard financial stability.
21 January	The HKMA conducts a roadshow in Dubai and Abu Dhabi to showcase Hong Kong as the offshore renminbi business centre and an asset management centre.
	The renminbi Real Time Gross Settlement system in Hong Kong is linked to the Shenzhen Financial Settlement System, enabling the extension of the operating hours of cross-border renminbi payment service from 4:30 p.m. to 10:30 p.m.
6 February	The HKMA announces measures to strengthen the fixing mechanism for the HKD Interest Settlement Rate (the Hong Kong Interbank Offered Rate or HIBOR).
22 February	The HKMA introduces the sixth round of prudential supervisory measures for mortgage lending.
1 March	The overseas ATM cash withdrawal capability for all ATM cards issued by authorized institutions (AIs) in Hong Kong is pre-set as "deactivated" to enhance the security of ATM services.
27 March	The HKMA announces the findings of the consultancy study on the development of Near Field Communication (NFC) mobile payment infrastructure in Hong Kong.
12 April	The inaugural Australia-Hong Kong Renminbi Trade and Investment Dialogue is held in Sydney.
	The HKMA holds a High-Level Seminar on Anti-Money Laundering and Counter-Financing of Terrorism for senior executives of AIs.
25 April	The HKMA removes the renminbi Net Open Position limit and the minimum requirement on the renminbi liquidity ratio. Conditions regarding the application of renminbi liquefiable assets for calculation of the statutory liquidity ratio are also uplifted.
3 May	The HKMA issues a statutory guideline on "Code of Conduct for Benchmark Submitters" in the Gazette, setting out supervisory requirements to enhance the robustness of the HIBOR fixing mechanism.
22 May	The Financial Services and the Treasury Bureau and HKMA jointly issue a public consultation paper to propose enhancing the regulatory regime for stored value facilities and retail payment systems in Hong Kong.
24 May	The size of the Government Bond Programme is expanded from $100 billion to $200 billion in 2013 following the passage of a Legislative Council (LegCo) Resolution which takes effect on 24 May.
11 June	The HKMA and the Hong Kong Trade Development Council jointly organise a seminar on "Hong Kong: The Premier Global Hub for Offshore Renminbi Business" in New York.
24 June	A total of $10 billion of 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.

28 June	The HKMA issues a circular to licensed banks setting out interim reporting requirements for over-the-counter (OTC) derivatives transactions before the new regulatory framework for the OTC derivatives market comes into effect.
30 June	Disclosure requirements associated with the first phase of Basel III implementation take effect.
10 July	The Securities and Futures (Amendment) Bill 2013, which is gazetted on 28 June to provide for the regulatory framework for the OTC derivatives market, is introduced into the LegCo.
18 July	The Securities and Futures Commission and the HKMA reach a settlement agreement with a bank in relation to its distribution of Lehman Brothers-related equity-linked notes to retail clients.
19 July	The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 is gazetted to provide a comparable taxation framework for some common types of Islamic bonds (sukuk) vis-à-vis conventional bonds.
26 July	The renminbi liquidity facility is enhanced to provide one-day funds (available on a next day basis) and overnight funds (available on the same day).
29 July	The reporting function of the OTC Derivatives Trade Repository of the HKMA (HKTR) is launched to support the commencement of the interim reporting requirements on 5 August.
23 August	The HKMA issues the "Code of Conduct for Reference Banks for TMA's CNH Hong Kong Interbank Offered Rate" as an annex to the statutory guideline on "Code of Conduct for Benchmark Submitters".
5 September	The Bank for International Settlements announces the results of the triennial survey on foreign exchange and derivatives market turnover — Hong Kong advances one place to rank fifth in the global foreign exchange market.
26 September	The third meeting of the Hong Kong-London Renminbi Forum is held in Hong Kong.
23 October	The HKMA introduces a Stable Funding Requirement to be implemented in 2014 requiring AIs with high loan growth to maintain sufficient stable funds.
28 October	The Treat Customers Fairly Charter is launched, with all 22 retail banks in Hong Kong signed up to the Charter pledging their commitment to implement the Charter principles.
22 November	The HKMA launches a consumer education programme to promote "smart and responsible" use of banking services.
25 November	The Hong Kong Association of Banks issues the Best Practice for NFC Mobile Payment in Hong Kong. The HKMA holds a seminar for industry representatives to exchange views on the innovations and future development of NFC mobile payment services.
3 December	The first meeting of the Joint Forum on Islamic Finance is held in Hong Kong to strengthen collaboration between Hong Kong and Malaysia in Islamic finance.
5 December	The first meeting of the Hong Kong-Malaysia Private Sector Dialogue on Offshore Renminbi Business is held in Kuala Lumpur.
11 December	The Electronic Bill Presentment and Payment service is launched, providing convenient one-stop bill payment services for the public.

Annex and Tables

Annex Authorized Institutions and Local Representative Offices at 31 December 2013

LICENSED BANKS

Incorporated in Hong Kong

Bank of China (Hong Kong) Limited
Bank of East Asia, Limited (The)
China 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 Chartered Bank (Hong Kong) Limited
Tai Sang Bank Limited
Tai Yau Bank, Limited
WING HANG BANK, LIMITED
Wing Lung Bank Limited

Deletion in 2013

Standard Bank Asia 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 J. Safra Sarasin AG
also known as:
Banque J. Safra Sarasin SA
Banca J. Safra Sarasin SA
Bank J. Safra Sarasin Ltd
(formerly known as
Bank Sarasin & Cie AG)
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 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.
Chugoku Bank, Ltd. (The)
CIMB Bank Berhad #
Citibank, N.A.
Commerzbank AG
Commonwealth Bank of Australia
Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.

Addition in 2013

Annex Authorized Institutions and Local Representative Offices at 31 December 2013 (continued)

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

CTBC Bank Co., Ltd
(formerly known as Chinatrust Commercial Bank, Ltd.)

DBS BANK LTD.

Deutsche Bank Aktiengesellschaft

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 AG
also known as:
LGT Bank Ltd.
LGT Bank SA
(formerly known as :
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 BANK PLC
(formerly known as 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 Bank, Ltd.
(formerly known as 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

Sumitomo Mitsui Trust Bank, Limited #

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 2013

RESTRICTED LICENCE BANKS

Incorporated in Hong Kong

ALLIED BANKING CORPORATION (HONG KONG) LIMITED

Banc of America Securities Asia Limited

Bank of China International Limited

Bank of Shanghai (Hong Kong) Limited
(formerly known as
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.

Siam Commercial Bank Public Company Limited (The)

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

Addition in 2013

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

Vietnam Finance Company Limited

Wing Hang Finance Company Limited

WOORI GLOBAL MARKETS ASIA LIMITED

Incorporated outside Hong Kong

NIL

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

Banco Security #

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.

Central Bank of India #

CHINA GUANGFA BANK CO., LTD.

CLEARSTREAM BANKING S.A.

Corporation Bank

Credit Industriel et Commercial

Credito Bergamasco S.p.A.

Doha Bank Q.S.C. #

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)

Metropolitan Bank and Trust Company

Nanto Bank, Ltd. (The)

National Bank of Canada

Nishi-Nippon City Bank, Ltd. (The)

Norinchukin Bank (The)

Ogaki Kyoritsu Bank, Ltd. (The)

Oita Bank, Ltd. (The)

P.T. Bank Central Asia

P.T. Bank Rakyat Indonesia (Persero)

Ping An 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

Swissquote Bank SA #
also known as:
Swissquote Bank AG
Swissquote Bank Inc.
Swissquote Bank Ltd

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 2013

Merrill Lynch Bank (Suisse) S.A.

MIG Banque SA

Addition in 2013

Table A Major Economic Indicators

		2009	2010	2011	2012	**2013**	
I.	**Gross Domestic Product**						
	Real GDP growth (%)	(2.5)	6.8	4.8	1.5	**2.9**	[a]
	Nominal GDP growth (%)	(2.8)	7.1	8.9	5.3	**4.2**	[a]
	Real growth of major expenditure components of GDP (%)						
	– Private consumption expenditure	0.2	6.1	8.4	4.1	**4.2**	[a]
	– Government consumption expenditure	2.3	3.4	2.5	3.6	**2.7**	[a]
	– Gross domestic fixed capital formation	(3.5)	7.7	10.2	6.8	**3.3**	[a]
	of which						
	– Building and construction	(5.5)	5.7	15.7	7.2	**(1.2)**	[a]
	– Machinery, equipment and computer software	(2.2)	6.5	12.3	10.2	**10.5**	[a]
	– Exports	(9.9)	16.8	3.9	1.9	**6.5**	[a]
	– Imports	(9.0)	17.4	4.6	2.9	**6.9**	[a]
	GDP at current market prices (US$ billion)	214.0	228.6	248.5	262.6	**273.7**	[a]
	Per capita GDP at current market prices (US$)	30,697	32,550	35,142	36,710	**38,074**	[a]
II.	**External Trade (HK$ billion)**						
	Merchandise trade [b]						
	– Domestic exports of goods	76.4	82.2	89.6	100.6	**92.4**	[a]
	– Re-exports of goods	2,423.7	2,986.3	3,330.5	3,491.2	**3,724.0**	[a]
	– Imports of goods	2,703.0	3,395.1	3,848.2	4,116.4	**4,394.9**	[a]
	– Merchandise trade balance	(202.8)	(326.6)	(428.1)	(524.6)	**(578.5)**	[a]
	Services trade						
	– Exports of services	672.8	829.0	941.2	1,003.0	**1,066.0**	[a]
	– Imports of services	339.3	398.1	438.6	455.4	**465.2**	[a]
	– Services trade balance	333.4	431.0	502.6	547.7	**600.9**	[a]
III.	**Fiscal Expenditure and Revenue (HK$ million, fiscal year)**						
	Total government expenditure [c]	292,525	301,360	364,037	377,324	**435,791**	[a]
	Total government revenue	318,442	376,481	437,723	442,150	**447,805**	[a]
	Consolidated surplus/deficit	25,917	75,121	73,686	64,825	**12,014**	[a]
	Reserve balance as at end of fiscal year [d]	520,281	595,402	669,088	733,914	**745,928**	[a]
IV.	**Prices (annual change, %)**						
	Consumer Price Index (A)	0.4	2.7	5.6	3.6	**5.1**	
	Composite Consumer Price Index	0.5	2.4	5.3	4.1	**4.3**	
	Trade Unit Value Indices						
	– Domestic exports	(0.2)	5.5	6.4	2.5	**2.2**	
	– Re-exports	1.2	4.6	8.0	3.4	**1.3**	
	– Imports	(0.1)	6.4	8.1	3.3	**0.9**	
	Property Price Indices						
	– Residential flats	0.6	24.4	20.6	13.3	**17.5**	[a]
	– Office premises	(9.7)	28.1	29.3	12.3	**22.5**	[a]
	– Retail premises	0.5	33.2	27.3	28.5	**20.4**	[a]
	– Flatted factory premises	(8.3)	31.5	35.4	27.2	**33.9**	[a]

Table A Major Economic Indicators (continued)

		2009	2010	2011	2012	**2013**
V.	**Labour**					
	Labour force (annual change, %)	0.6	(0.8)	2.0	2.2	**2.3** [a]
	Employment (annual change, %)	(1.2)	0.2	2.9	2.4	**2.3** [a]
	Unemployment rate (annual average, %)	5.3	4.3	3.4	3.3	**3.3** [a]
	Underemployment rate (annual average, %)	2.3	2.0	1.7	1.5	**1.5** [a]
	Employment ('000)	3,468	3,474	3,576	3,661	**3,744** [a]
VI.	**Money Supply (HK$ billion)**					
	HK$ money supply					
	– M1	671.2	730.1	794.7	920.9	**1,000.3**
	– M2 [e]	3,587.7	3,866.8	4,046.2	4,537.4	**4,795.1**
	– M3 [e]	3,604.8	3,878.2	4,055.4	4,545.6	**4,806.0**
	Total money supply					
	– M1	901.8	1,017.2	1,127.3	1,377.4	**1,510.9**
	– M2	6,602.3	7,136.3	8,057.5	8,950.0	**10,054.4**
	– M3	6,626.8	7,156.3	8,081.1	8,970.4	**10,083.2**
VII.	**Interest Rates (end of period, %)**					
	Three-month interbank rate [f]	0.14	0.28	0.38	0.40	**0.38**
	Savings deposit	0.01	0.01	0.01	0.01	**0.01**
	One-month time deposit	0.01	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'	0.11	0.21	0.53	0.32	**0.39**
VIII.	**Exchange Rates (end of period)**					
	HK$/US$	7.756	7.775	7.766	7.751	**7.754**
	Trade-weighted Effective Exchange Rate Index (Jan 2010=100)	100.3	96.3	94.9	94.2	**94.8**
IX.	**Foreign Currency Reserve Assets (US$ billion)** [g]	255.8	268.7	285.4	317.4	**311.2**
X.	**Stock Market (end of period figures)**					
	Hang Seng Index	21,873	23,035	18,434	22,657	**23,306**
	Average price/earnings ratio	18.1	16.7	9.7	10.5	**11.2**
	Market capitalisation (HK$ billion)	17,769.3	20,942.3	17,452.7	21,871.7	**23,908.8**

(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) Refers to three-month Hong Kong Dollar Interest Settlement Rates.

(g) Excludes unsettled forward transactions but includes gold.

Table B Performance Ratios of the Banking Sector [a]

	All Authorized Institutions					Retail Banks				
	2009 %	2010 %	2011 %	2012 %	**2013 %**	2009 %	2010 %	2011 %	2012 %	**2013 %**
Asset Quality [b]										
As % of total credit exposures [c]										
Total outstanding provisions/impairment allowances	0.63	0.47	0.42	0.39	**0.35**	0.56	0.39	0.33	0.25	**0.22**
Classified [d] exposures:										
– Gross	1.10	0.60	0.49	0.40	**0.36**	1.00	0.57	0.42	0.34	**0.31**
– Net of specific provisions/individual impairment allowances	0.71	0.34	0.28	0.24	**0.22**	0.66	0.33	0.24	0.23	**0.22**
– Net of all provisions/impairment allowances	0.47	0.14	0.07	0.01	**0.00**	0.44	0.18	0.09	0.09	**0.08**
As % of total loans										
Total outstanding provisions/impairment allowances	0.96	0.71	0.63	0.60	**0.55**	0.84	0.59	0.50	0.39	**0.35**
Classified [d] loans:										
– Gross	1.61	0.83	0.69	0.58	**0.54**	1.38	0.77	0.59	0.48	**0.48**
– Net of specific provisions/individual impairment allowances	1.07	0.46	0.41	0.35	**0.35**	0.92	0.45	0.34	0.32	**0.34**
– Net of all provisions/impairment allowances	0.65	0.13	0.06	(0.02)	**(0.01)**	0.54	0.18	0.09	0.09	**0.12**
Overdue > 3 months and rescheduled loans	0.92	0.58	0.47	0.42	**0.36**	0.88	0.60	0.49	0.39	**0.33**
Profitability										
Return on assets (operating profit)	0.73	0.82	0.80	0.84	**1.03**	1.09	1.11	1.11	1.18	**1.30**
Return on assets (post-tax profit)	0.64	0.76	0.72	0.74	**1.05**	0.97	1.01	1.02	1.06	**1.40**
Net interest margin	1.11	1.02	0.98	1.08	**1.12**	1.48	1.32	1.24	1.36	**1.40**
Cost-to-income ratio	58.0	58.1	55.4	54.8	**49.0**	49.7	49.9	46.6	45.8	**42.2**
Bad debt charge to total assets	0.13	0.05	0.07	0.08	**0.06**	0.11	0.03	0.04	0.04	**0.04**
Liquidity										
Loan to deposit ratio (all currencies)	51.5	61.6	66.9	67.1	**70.4**	46.3	52.8	55.3	54.8	**56.3**
Loan to deposit [e] ratio (Hong Kong dollar)	71.2	78.1	84.5	79.8	**82.1**	65.2	70.5	76.2	72.3	**74.8**

	Surveyed Institutions				
	2009 %	2010 %	2011 %	2012 %	**2013 %**
Asset Quality					
Delinquency ratio of residential mortgage loans	0.03	0.01	0.01	0.02	**0.02**
Credit card receivables					
– Delinquency ratio	0.34	0.20	0.19	0.20	**0.20**
– Charge-off ratio	3.71	1.91	1.49	1.70	**1.84**

	Locally Incorporated Licensed Banks				
	2009 %	2010 %	2011 %	2012 %	**2013 %**
Profitability					
Operating profit to shareholders' funds	14.8	14.2	15.5	15.0	**14.1**
Post-tax profit to shareholders' funds	13.2	12.9	14.2	13.5	**15.3**
Capital Adequacy					
Equity to assets ratio [b]	8.5	8.3	7.9	8.5	**8.5**

	All Locally Incorporated Authorized Institutions				
	2009 %	2010 %	2011 %	2012 %	**2013 %**
Capital Adequacy Ratio (Consolidated) [f]	16.8	15.8	15.8	15.7	**15.9**

(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 2013, all locally incorporated AIs started to report their capital adequacy positions according to the Banking (Capital) Rules (i.e. the Basel III framework).

Table C Authorized Institutions: Domicile and Parentage

	2009	2010	2011	2012	**2013**
Licensed Banks					
(i) Incorporated in Hong Kong	23	23	23	22	**21**
(ii) Incorporated outside Hong Kong	122	123	129	133	**135**
Total	145	146	152	155	**156**
Restricted Licence Banks					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	1	1	1	1	**1**
(b) incorporated outside Hong Kong	5	5	5	6	**6**
(ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong	16	13	12	12	**12**
(iii) Bank related	1	1	1	1	**1**
(iv) Others	3	1	1	1	**1**
Total	26	21	20	21	**21**
Deposit-taking Companies					
(i) Subsidiaries of licensed banks:					
(a) incorporated in Hong Kong	7	6	6	6	**6**
(b) incorporated outside Hong Kong	4	4	4	3	**3**
(ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong	7	7	7	7	**7**
(iii) Bank related	2	2	2	2	**2**
(iv) Others	8	7	7	6	**6**
Total	28	26	26	24	**24**
All Authorized Institutions	199	193	198	200	**201**
Local Representative Offices	71	67	61	60	**62**

Table D Authorized Institutions: Region/Economy of Beneficial Ownership

Region/Economy	Licensed Banks					Restricted Licence Banks					Deposit-taking Companies				
	09	10	11	12	**13**	09	10	11	12	**13**	09	10	11	12	**13**
Asia & Pacific															
Hong Kong	10	10	10	9	**9**	–	–	–	–	**–**	9	7	7	7	**7**
Australia	4	4	5	5	**5**	–	–	–	–	**–**	–	–	–	–	**–**
Mainland China	14	14	15	17	**17**	2	2	2	2	**2**	3	2	2	2	**2**
India	12	12	12	12	**12**	–	–	–	–	**–**	1	1	1	1	**1**
Indonesia	1	1	1	1	**1**	1	1	1	1	**1**	–	–	–	–	**–**
Japan	10	10	10	10	**11**	2	1	1	1	**1**	3	3	3	2	**2**
Malaysia	3	3	3	3	**4**	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**	2	2	2	2	**2**
Singapore	4	5	5	5	**5**	–	–	–	–	**–**	–	–	–	–	**–**
South Korea	5	5	5	5	**5**	2	2	2	2	**2**	4	4	4	4	**4**
Taiwan	18	19	19	19	**19**	–	–	–	–	**–**	1	1	1	1	**1**
Thailand	1	1	1	1	**1**	4	4	3	3	**3**	–	–	–	–	**–**
Vietnam	–	–	–	–	**–**	–	–	–	–	**–**	1	1	1	1	**1**
Sub-Total	85	87	89	90	**92**	13	11	10	10	**10**	27	24	24	23	**23**
Europe															
Austria	1	1	1	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Belgium	2	1	1	1	**1**	1	1	1	1	**1**	–	–	–	–	**–**
Denmark	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
France	8	9	9	9	**9**	3	3	2	2	**2**	–	–	–	–	**–**
Germany	5	4	4	4	**4**	–	–	–	–	**–**	–	–	–	–	**–**
Italy	4	4	4	4	**4**	–	–	–	–	**–**	–	–	–	–	**–**
Luxembourg	–	–	–	–	**–**	1	1	1	–	**–**	–	–	–	–	**–**
Netherlands	5	4	4	3	**3**	–	–	–	–	**–**	–	–	–	–	**–**
Spain	2	2	2	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Sweden	1	1	2	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Switzerland	3	4	5	6	**6**	–	–	–	–	**–**	–	–	–	–	**–**
United Kingdom	10	11	11	11	**11**	1	–	–	–	**–**	–	1	1	1	**1**
Sub-Total	41	41	43	44	**44**	6	5	4	3	**3**	–	1	1	1	**1**
Middle East															
Bahrain	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
Iran	1	1	1	1	**1**	–	–	–	–	**–**	–	–	–	–	**–**
United Arab Emirates	2	2	2	2	**2**	1	1	1	1	**1**	–	–	–	–	**–**
Sub-Total	3	3	3	3	**3**	1	1	1	1	**1**	–	–	–	–	**–**
North America															
Canada	5	5	5	5	**5**	1	1	1	3	**3**	–	–	–	–	**–**
United States	10	9	9	9	**9**	5	3	4	4	**4**	1	1	1	–	**–**
Sub-Total	15	14	14	14	**14**	6	4	5	7	**7**	1	1	1	–	**–**
South Africa	1	1	2	2	**1**	–	–	–	–	**–**	–	–	–	–	**–**
Bermuda	–	–	–	–	**–**	–	–	–	–	**–**	–	–	–	–	**–**
Others	–	–	1	2	**2**	–	–	–	–	**–**	–	–	–	–	**–**
Grand Total	145	146	152	155	**156**	26	21	20	21	**21**	28	26	26	24	**24**

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

Positions at 31 December 2013	Number of Overseas Banks [b]					Licensed Banks [c]					Restricted Licence Banks [c]					Deposit-Taking Companies [c]					Local Representative Offices				
	09	10	11	12	**13**	09	10	11	12	**13**	09	10	11	12	**13**	09	10	11	12	**13**	09	10	11	12	**13**
World Ranking [a]																									
1 – 20	20	20	20	20	**20**	37	38	40	39	**40**	8	6	6	6	**5**	–	–	–	–	**–**	5	5	3	2	**–**
21 – 50	22	23	26	26	**26**	22	24	21	23	**24**	4	3	3	3	**3**	1	2	2	2	**2**	4	3	5	5	**4**
51 – 100	28	27	27	24	**24**	21	17	21	22	**23**	1	1	1	1	**2**	5	3	3	3	**3**	14	16	14	3	**4**
101 – 200	31	30	40	40	**43**	15	17	23	25	**24**	–	–	–	–	**3**	3	3	4	3	**2**	15	12	14	21	**22**
201 – 500	52	51	43	48	**47**	28	30	24	25	**26**	8	6	5	5	**4**	1	1	2	3	**3**	18	16	14	17	**16**
Sub-total	153	151	156	158	**160**	123	126	129	134	**137**	21	16	15	15	**17**	10	9	11	11	**10**	56	52	50	48	**46**
Others	52	48	43	42	**45**	22	20	23	21	**19**	5	5	5	6	**4**	18	17	15	13	**14**	15	15	11	12	**16**
Total	205	199	199	200	**205**	145	146	152	155	**156**	26	21	20	21	**21**	28	26	26	24	**24**	71	67	61	60	**62**

(a) Top 500 banks/banking groups in the world ranked by total assets. Figures are extracted from *The Banker*, July 2013 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

(HK$ billion)	2009 HK$	2009 F/CY	2009 Total	2010 HK$	2010 F/CY	2010 Total	2011 HK$	2011 F/CY	2011 Total	2012 HK$	2012 F/CY	2012 Total	2013 HK$	2013 F/CY	2013 Total
Assets															
Loans to customers	2,401	887	3,288	2,824	1,403	4,228	3,160	1,921	5,081	3,333	2,234	5,567	3,606	2,851	6,457
– Inside Hong Kong [(a)]	2,227	419	2,646	2,568	695	3,262	2,809	902	3,711	2,934	1,046	3,980	3,120	1,410	4,530
– Outside Hong Kong [(b)]	174	468	642	257	708	965	351	1,018	1,369	399	1,188	1,587	487	1,441	1,928
Interbank lending	475	3,282	3,757	399	3,743	4,142	351	4,120	4,471	390	4,001	4,391	424	4,374	4,798
– Inside Hong Kong	231	317	548	181	473	654	205	444	649	234	424	658	255	530	785
– Outside Hong Kong	244	2,966	3,209	218	3,270	3,488	146	3,676	3,822	157	3,577	3,734	169	3,844	4,013
Negotiable certificates of deposit (NCDs)	41	62	102	80	54	133	90	104	194	133	159	291	134	173	306
Negotiable debt instruments, other than NCDs	816	1,541	2,357	893	1,737	2,630	862	1,865	2,727	822	2,115	2,937	912	2,674	3,586
Other assets	666	465	1,131	550	608	1,158	566	704	1,270	775	897	1,672	727	1,069	1,797
Total Assets	4,399	6,236	10,635	4,746	7,545	12,291	5,029	8,713	13,742	5,453	9,406	14,859	5,803	11,141	16,944
Liabilities															
Deposits from customers [(c)]	3,374	3,007	6,381	3,617	3,245	6,862	3,740	3,851	7,591	4,176	4,120	8,296	4,391	4,787	9,178
Interbank borrowing	473	2,409	2,882	466	3,222	3,688	547	3,479	4,026	576	3,393	3,969	613	4,105	4,718
– Inside Hong Kong	228	321	549	178	478	657	201	450	651	236	434	670	311	602	913
– Outside Hong Kong	245	2,088	2,332	288	2,744	3,032	346	3,029	3,375	340	2,959	3,299	302	3,503	3,805
Negotiable certificates of deposit	69	27	96	114	61	175	144	239	383	210	426	636	222	616	838
Other liabilities	762	515	1,277	845	720	1,565	910	831	1,741	1,033	924	1,957	1,134	1,076	2,209
Total Liabilities	4,678	5,958	10,635	5,043	7,248	12,291	5,341	8,401	13,742	5,996	8,863	14,859	6,360	10,584	16,944

Retail Banks

(HK$ billion)	2009 HK$	2009 F/CY	2009 Total	2010 HK$	2010 F/CY	2010 Total	2011 HK$	2011 F/CY	2011 Total	2012 HK$	2012 F/CY	2012 Total	2013 HK$	2013 F/CY	2013 Total
Assets															
Loans to customers	1,963	352	2,315	2,310	622	2,932	2,567	784	3,351	2,724	906	3,630	2,966	1,195	4,161
– Inside Hong Kong [(a)]	1,857	229	2,086	2,150	392	2,542	2,346	462	2,808	2,477	519	2,996	2,664	750	3,415
– Outside Hong Kong [(b)]	106	123	229	160	230	391	221	322	543	248	386	634	302	445	747
Interbank lending	263	1,162	1,425	172	1,439	1,611	172	1,639	1,811	200	1,449	1,648	207	1,764	1,972
– Inside Hong Kong	168	186	353	112	284	396	123	205	329	152	186	337	148	174	323
– Outside Hong Kong	96	976	1,072	60	1,155	1,215	49	1,433	1,482	48	1,263	1,311	59	1,590	1,649
Negotiable certificates of deposit (NCDs)	28	30	58	54	27	81	57	47	104	90	90	180	101	112	213
Negotiable debt instruments, other than NCDs	692	1,104	1,795	620	1,257	1,876	620	1,314	1,934	618	1,509	2,127	709	1,791	2,500
Other assets	477	292	769	432	396	828	438	470	908	589	600	1,189	581	722	1,303
Total Assets	3,424	2,940	6,364	3,588	3,740	7,328	3,855	4,253	8,108	4,220	4,554	8,774	4,565	5,585	10,150
Liabilities															
Deposits from customers [(c)]	3,012	1,992	5,004	3,276	2,280	5,556	3,368	2,692	6,059	3,768	2,854	6,622	3,967	3,430	7,396
Interbank borrowing	165	265	430	136	486	622	165	523	687	183	475	658	239	770	1,009
– Inside Hong Kong	42	83	124	41	291	332	55	246	301	59	181	240	134	364	498
– Outside Hong Kong	123	182	305	95	195	290	109	277	386	123	294	417	105	406	511
Negotiable certificates of deposit	25	11	36	41	22	63	64	99	163	45	123	168	57	175	232
Other liabilities	625	269	894	682	406	1,088	720	478	1,198	825	501	1,326	916	596	1,512
Total Liabilities	3,827	2,536	6,364	4,134	3,194	7,328	4,316	3,792	8,108	4,820	3,954	8,774	5,179	4,971	10,150

(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	2012	4,005	912	1,242	2,625	6,074	14,859
	2013	**4,941**	**1,215**	**999**	**2,798**	**6,991**	**16,944**
Deposits from Customers	2012	2,274	145	426	1,379	4,072	8,296
	2013	**2,760**	**166**	**440**	**1,334**	**4,478**	**9,178**
Loans to Customers	2012	1,687	395	214	874	2,398	5,567
	2013	**2,052**	**466**	**230**	**983**	**2,727**	**6,457**
Loans to Customers	2012	1,204	238	174	556	1,808	3,980
Inside Hong Kong [a]	**2013**	**1,417**	**260**	**198**	**615**	**2,039**	**4,530**
Loans to Customers	2012	483	157	39	318	590	1,587
Outside Hong Kong [b]	**2013**	**634**	**206**	**32**	**368**	**688**	**1,928**

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

(b) 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)	2012 HK$	2012 F/CY	2012 Total	**2013 HK$**	**2013 F/CY**	**2013 Total**
Assets						
Loans to customers	173	313	486	**273**	**617**	**891**
– Inside Hong Kong [a]	125	143	268	**186**	**364**	**550**
– Outside Hong Kong [b]	48	170	218	**87**	**253**	**341**
Interbank lending	39	(119)	(79)	**33**	**373**	**406**
– Inside Hong Kong	29	(20)	9	**21**	**106**	**127**
– Outside Hong Kong	10	(99)	(88)	**12**	**267**	**279**
All other assets	211	499	710	**43**	**745**	**788**
Total Assets	424	693	1,117	**350**	**1,735**	**2,085**
Liabilities						
Deposits from customers [c]	436	269	705	**215**	**667**	**882**
Interbank borrowing	29	(86)	(57)	**37**	**712**	**749**
– Inside Hong Kong	35	(16)	19	**75**	**168**	**243**
– Outside Hong Kong	(6)	(70)	(76)	**(38)**	**544**	**505**
All other liabilities	189	279	469	**112**	**342**	**455**
Total Liabilities	654	463	1,117	**364**	**1,721**	**2,085**
Net Interbank Borrowing/(Lending)	(11)	33	22	**4**	**338**	**342**
Net Customer Lending/(Borrowing)	(263)	44	(219)	**59**	**(50)**	**9**

Retail Banks

Increase/(Decrease) in (HK$ billion)	2012 HK$	2012 F/CY	2012 Total	**2013 HK$**	**2013 F/CY**	**2013 Total**
Assets						
Loans to customers	157	122	279	**242**	**289**	**531**
– Inside Hong Kong [a]	130	57	187	**188**	**231**	**419**
– Outside Hong Kong [b]	27	65	91	**54**	**58**	**113**
Interbank lending	27	(190)	(163)	**8**	**316**	**323**
– Inside Hong Kong	28	(19)	9	**(3)**	**(12)**	**(15)**
– Outside Hong Kong	(1)	(171)	(172)	**11**	**327**	**338**
All other assets	181	369	550	**95**	**425**	**520**
Total Assets	365	301	666	**345**	**1,030**	**1,375**
Liabilities						
Deposits from customers [c]	400	162	562	**199**	**576**	**775**
Interbank borrowing	18	(48)	(30)	**57**	**295**	**352**
– Inside Hong Kong	4	(65)	(61)	**75**	**183**	**258**
– Outside Hong Kong	14	18	31	**(18)**	**111**	**94**
All other liabilities	87	47	134	**103**	**146**	**249**
Total Liabilities	505	162	666	**359**	**1,017**	**1,375**
Net Interbank Borrowing/(Lending)	(9)	142	133	**49**	**(21)**	**28**
Net Customer Lending/(Borrowing)	(243)	(40)	(283)	**43**	**(286)**	**(243)**

(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$	F/CY	Total	%	Deposits from Customers [a] HK$	F/CY	Total	%
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	2,213	5,504	99	4,168	4,108	8,276	100
Restricted licence banks	20	16	35	1	3	10	13	–
Deposit-taking companies	23	5	27	–	5	2	7	–
Total	3,333	2,234	5,567	100	4,176	4,120	8,296	100
2013								
Licensed banks	**3,562**	**2,823**	**6,385**	**99**	**4,380**	**4,770**	**9,150**	**100**
Restricted licence banks	**21**	**22**	**43**	**1**	**5**	**16**	**21**	**–**
Deposit-taking companies	**24**	**5**	**29**	**–**	**6**	**2**	**7**	**–**
Total	**3,606**	**2,851**	**6,457**	**100**	**4,391**	**4,787**	**9,178**	**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	2009		2010		2011		2012		**2013**	
(HK$ billion)	HK$	%	HK$	%	HK$	%	HK$	%	**HK$**	**%**
Hong Kong's visible trade	175	7	274	8	351	9	383	10	**550**	**12**
Manufacturing	127	5	162	5	189	5	184	5	**217**	**5**
Transport and transport equipment	151	6	168	5	193	5	216	5	**248**	**5**
Building, construction and property development, and investment	687	26	827	25	918	25	928	23	**993**	**22**
Wholesale and retail trade	150	6	229	7	314	8	351	9	**418**	**9**
Financial concerns (other than authorized institutions)	186	7	235	7	264	7	273	7	**327**	**7**
Individuals:										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	52	2	51	2	46	1	42	1	**42**	**1**
– to purchase other residential properties	647	24	745	23	805	22	873	22	**909**	**20**
– other purposes	222	8	256	8	292	8	333	8	**390**	**9**
Others	250	9	315	10	340	9	397	10	**437**	**10**
Total [a]	2,646	100	3,262	100	3,711	100	3,980	100	**4,530**	**100**

Retail Banks

Sector	2009		2010		2011		2012		**2013**	
(HK$ billion)	HK$	%	HK$	%	HK$	%	HK$	%	**HK$**	**%**
Hong Kong's visible trade	131	6	208	8	242	9	257	9	**349**	**10**
Manufacturing	87	4	114	4	129	5	121	4	**139**	**4**
Transport and transport equipment	95	5	102	4	115	4	129	4	**156**	**5**
Building, construction and property development, and investment	556	27	663	26	719	26	734	24	**785**	**23**
Wholesale and retail trade	102	5	161	6	207	7	222	7	**266**	**8**
Financial concerns (other than authorized institutions)	84	4	106	4	113	4	118	4	**169**	**5**
Individuals:										
– to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme	52	2	51	2	46	2	42	1	**42**	**1**
– to purchase other residential properties	634	30	734	29	794	28	860	29	**896**	**26**
– other purposes	186	9	209	8	245	9	270	9	**321**	**9**
Others	159	8	193	8	199	7	243	8	**292**	**9**
Total [a]	2,086	100	2,542	100	2,808	100	2,996	100	**3,415**	**100**

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

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)]								
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	2,011	1,526	4,176	577	1,982	1,209	3,768
2013	**686**	**2,077**	**1,628**	**4,391**	**610**	**2,048**	**1,309**	**3,967**
Foreign Currency								
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	1,380	2,284	4,120	293	1,191	1,370	2,854
2013	**511**	**1,619**	**2,657**	**4,787**	**305**	**1,401**	**1,724**	**3,430**
Total								
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	3,392	3,809	8,296	869	3,173	2,579	6,622
2013	**1,197**	**3,696**	**4,285**	**9,178**	**914**	**3,449**	**3,033**	**7,396**

(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)	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)	**2013 Net Claims on/ (Liabilities to) Banks Outside Hong Kong**	**2013 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong**	**2013 Total Net Claims/ (Liabilities)**
Asia & Pacific	1,803	(138)	1,665	**2,284**	**(81)**	**2,203**
Mainland China	1,103	(79)	1,024	**2,180**	**138**	**2,318**
South Korea	199	44	243	**155**	**23**	**179**
Australia	236	27	264	**154**	**22**	**176**
India	81	120	200	**56**	**92**	**149**
Malaysia	42	(24)	17	**66**	**(15)**	**51**
Indonesia	9	(7)	2	**8**	**6**	**14**
Vietnam	6	1	7	**5**	**2**	**8**
Sri Lanka	4	2	5	**5**	**2**	**7**
Bangladesh	8	0	7	**7**	**0**	**7**
Laos	0	0	0	**5**	**0**	**5**
Cambodia	2	2	4	**2**	**2**	**5**
Pakistan	0	0	(1)	**0**	**0**	**1**
Papua New Guinea	0	0	0	**(1)**	**1**	**0**
Maldives	0	0	1	**0**	**0**	**0**
New Zealand	2	(2)	0	**3**	**(3)**	**0**
Myanmar	(1)	0	(1)	**0**	**0**	**(1)**
Vanuatu	0	(1)	(1)	**0**	**(1)**	**(1)**
Republic of Kazakhstan	0	1	1	**0**	**(2)**	**(2)**
Thailand	44	(24)	20	**38**	**(44)**	**(6)**
Nepal	(6)	0	(6)	**(6)**	**0**	**(6)**
Brunei	(7)	(2)	(9)	**(5)**	**(2)**	**(7)**
Taiwan	141	(236)	(95)	**230**	**(242)**	**(12)**
Philippines	18	(2)	16	**(8)**	**(4)**	**(12)**
Western Samoa	0	(15)	(15)	**0**	**(17)**	**(17)**
Singapore	251	(101)	149	**7**	**(93)**	**(86)**
Macau SAR	(95)	(19)	(115)	**(49)**	**(41)**	**(90)**
Japan	(228)	178	(50)	**(564)**	**89**	**(475)**
Others	(4)	1	(3)	**(3)**	**4**	**0**
North America	(240)	186	(54)	**(53)**	**223**	**170**
United States	(261)	167	(93)	**(51)**	**187**	**136**
Canada	20	19	39	**(2)**	**36**	**34**
Caribbean	46	(46)	(1)	**(9)**	**(74)**	**(83)**
Cayman Islands	(10)	14	4	**(7)**	**14**	**7**
Panama	0	3	3	**3**	**(1)**	**1**
Bahamas	56	(3)	53	**(4)**	**3**	**(1)**
Barbados	0	0	0	**0**	**(5)**	**(5)**
Bermuda	0	(3)	(3)	**(1)**	**(10)**	**(10)**
Others	0	(58)	(58)	**(1)**	**(75)**	**(76)**
Africa	(1)	(25)	(27)	**3**	**(57)**	**(54)**
Mauritius	0	1	1	**6**	**(2)**	**5**
Kenya	0	1	1	**0**	**0**	**1**
Liberia	0	(1)	(1)	**0**	**(1)**	**(1)**
South Africa	2	(4)	(2)	**0**	**(2)**	**(2)**
Nigeria	(4)	0	(4)	**(4)**	**0**	**(4)**
Others	0	(21)	(22)	**0**	**(53)**	**(52)**

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

Region/Economy (HK$ billion)	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)	2013 Net Claims on/ (Liabilities to) Banks Outside Hong Kong	2013 Net Claims on/ (Liabilities to) Non-bank Customers Outside Hong Kong	2013 Total Net Claims/ (Liabilities)
Latin America	4	(1)	3	8	(1)	6
Venezuela	3	(1)	2	6	(1)	5
Peru	0	2	2	0	4	4
Mexico	1	3	4	1	2	2
Brazil	2	0	2	1	1	1
Chile	0	0	1	0	(2)	(1)
Others	(2)	(5)	(7)	0	(5)	(5)
Eastern Europe	1	(2)	(1)	4	(2)	2
Western Europe	248	98	345	(158)	84	(73)
Germany	79	38	117	12	35	47
United Kingdom	70	10	80	47	(3)	44
Luxembourg	16	(1)	16	34	2	36
France	91	40	131	(9)	37	29
Norway	5	(2)	3	8	1	9
Republic of Ireland	0	4	4	0	8	8
Sweden	6	4	10	3	4	6
Turkey	6	0	6	6	0	6
Jersey	5	0	4	7	(3)	4
Finland	1	0	1	1	0	1
Iceland	1	0	1	0	0	0
Austria	3	0	4	1	0	0
Denmark	6	0	6	1	0	0
Guernsey	1	(1)	0	2	(1)	0
Portugal	0	0	(1)	0	0	0
Gibraltar	0	(1)	(1)	0	(1)	(1)
Greece	0	0	0	0	(1)	(1)
Liechtenstein	0	(1)	0	(1)	0	(2)
Switzerland	50	(6)	44	12	(15)	(2)
Malta	(3)	1	(3)	(6)	1	(5)
Belgium	8	0	8	(28)	(3)	(31)
Italy	(34)	(2)	(37)	(52)	(3)	(55)
Spain	(22)	0	(23)	(54)	(1)	(55)
Netherlands	(41)	16	(24)	(141)	29	(111)
Others	0	0	1	0	0	0
Middle East	(29)	55	26	18	27	45
United Arab Emirates	1	29	30	18	17	35
Bahrain	9	0	10	16	1	17
Qatar	1	17	19	2	4	6
Saudi Arabia	(27)	10	(17)	(6)	9	3
Egypt	(1)	1	1	(1)	1	1
Oman	(3)	0	(2)	(1)	1	(1)
Israel	0	(1)	(1)	0	(1)	(2)
Kuwait	(11)	(2)	(13)	(10)	(4)	(15)
Others	0	0	0	0	0	0
Others [a]	56	2	58	68	1	69
Overall Total	1,887	128	2,016	2,164	120	2,284

(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

ABS Ordinance	–	Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013
AI	–	Authorized institution
APEC	–	Asia-Pacific Economic Co-operation
AML	–	Anti-money laundering
ASEAN	–	Association of Southeast Asian Nations
BCAR 2012	–	Banking (Capital) (Amendment) Rules 2012
BDAR 2013	–	Banking (Disclosure) (Amendment) Rules 2013
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
EBPP	–	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
FASB	–	Financial Accounting Standards Board
F/CY	–	Foreign currency
FMIs	–	Financial market infrastructures
FS	–	Financial Secretary
FSB	–	Financial Stability Board
FSAP	–	Financial Sector Assessment Programme
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
HKICL	–	Hong Kong Interbank Clearing Limited
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
IASB	–	International Accounting Standards Board
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
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
QDII	–	Qualified Domestic Institutional Investor
RMB	–	Renminbi
RMC Division	–	Risk Management and Compliance Division
RPS	–	Retail Payment Systems
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
SVF	–	Stored Value Facilities
TMA	–	Treasury Markets Association

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

HKMA Background Brief No. 4 – Financial Infrastructure in Hong Kong (Second Edition)

HKMA Background Brief No. 5 – Reserves Management in Hong Kong

Money in Hong Kong

Money and Banking in Hong Kong: A Historical Timeline

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

HKMA publications may be purchased or obtained from the **HKMA Information Centre**, 55th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. The HKMA Information Centre consists of an Exhibition Area and a Library. The Centre introduces the work of the HKMA and houses books, journals and other texts on central banking and related subjects. The Centre is open to the public six days a week.

Most HKMA publications are also available for downloading free of charge from the HKMA website (www.hkma.gov.hk). A mail order form for the purchase of print publications can be found on the website.

The main texts of the regular briefings by the HKMA to the Legislative Council Panel on Financial Affairs are available online.

The HKMA website contains detailed and extensive information on the whole range of the HKMA's work. This information includes press releases, statistics, speeches, guidelines and circulars, research reports, and features on topical issues.

Production : REF Financial Press Limited
Printing : Magnum Offset Printing Co, Ltd

ISSN 2221-5751 (print version)
ISSN 1726-975X (online version)

HK$100

HONG KONG MONETARY AUTHORITY

55/F, Two International Finance Centre,
8 Finance Street, Central, Hong Kong
Telephone : (852) 2878 8196
Facsimile : (852) 2878 8197
E-mail : hkma@hkma.gov.hk

www.hkma.gov.hk