



HONG KONG MONETARY AUTHORITY
香港金融管理局

2014

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

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

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

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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 2014 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 2014

Economic and Financial Environment

Hong Kong's economy grows at a slower pace amid softer growth in domestic demand and a continued weak external trade performance. The Hang Seng Index records modest gains in a sharply fluctuating market, while the residential property market turns more active with housing prices picking up and trading activity rebounding.

Hong Kong's banking sector remains resilient. Retail banks are well capitalised with sound asset quality. Profitability grows modestly while credit expansion eases.

Monetary Stability

The Hong Kong dollar exchange rate against the US dollar remains stable, despite repeated triggering of the strong-side Convertibility Undertaking in July and early August. The money market functions normally with ample liquidity, and the Linked Exchange Rate System continues to command high public and market confidence. The HKMA launches the world's first structured coin collection scheme using mobile approach to help the public get value for their coins while reducing the need to mint new coins.

Banking Stability

The HKMA steps up supervision of banks' credit growth and Mainland-related business in light of the increasing challenges posed by the divergence in advanced economies, a slowdown in Mainland China and the active local property market.

The HKMA collaborates with other regulators to take robust supervisory measures on the sale of investment and insurance products. The HKMA has worked with the industry to complete the review of the Code of Banking Practice to strengthen consumer protection. An enhanced competency framework for private wealth management practitioners is launched to raise professional standards. The year also sees the implementation of the second phase of the Basel III standards, and progress is made on setting up a resolution regime for financial institutions and measures to enhance the Deposit Protection Scheme.

International Financial Centre

Hong Kong's role as the premier hub for renminbi business strengthens as renminbi activities expand globally. The Shanghai-Hong Kong Stock Connect is launched, opening up a new channel for cross-border use and circulation of renminbi. Renminbi daily conversion limit for Hong Kong residents is no longer applied by banks with effect from 17 November. The HKMA introduces measures to enhance renminbi liquidity in Hong Kong to facilitate market development.

The first sukuk (Islamic bond) under the Government Bond Programme is successfully issued in September. The US\$1 billion 5-year issuance attracts strong demand from global investors and receives international recognition.

The HKMA becomes a member of The South-East Asian Central Banks (SEACEN) group, which promotes training and research for central banks in the region.

The legislative framework for a new regulatory regime for stored value facilities and retail payment systems is finalised.

Reserves Management

The Exchange Fund records an investment income of \$44.7 billion giving a return of 1.4% despite the difficult investment environment. Total assets of the Fund reach \$3,149.0 billion at the end of 2014.

The HKMA continues to diversify part of the Fund's investment into various asset classes. At the end of 2014, the market value of investments under the Long-Term Growth Portfolio totals \$115.2 billion, made up of \$80.5 billion in private equity and \$34.7 billion in real estate, with outstanding investment commitments amounting to \$80.9 billion.

Corporate Functions

The HKMA continues to strengthen its connection with the community through timely dissemination of information, effective communication with the media, and other public education activities. Robust control processes are in place to ensure efficient deployment of resources. HKMA staff maintain professionalism in upholding best practices in governance, financial budgeting and disclosure, internal controls, risk management and general support. Staff members also actively participate in green initiatives and charity work.



Chief Executive's Statement

2014 was another unusual and volatile year for the global economy and financial markets, which were in no small part affected by the unconventional monetary policies of the advanced economies. It was a highly challenging year for the HKMA.

While the US economy was recovering steadily, growth in Europe and Japan was weak, resulting in divergent monetary policy paths in the major economies. The US Federal Reserve started to taper its asset purchase programme in January 2014 and wrapped up the programme in October as planned. Nevertheless, there were still considerable uncertainties in the timing and pace of interest rate hikes. The euro-zone economy stagnated, and while the long-awaited monetary easing finally materialised, the prospects were somehow undermined by the outcome of the Greek election early this year. Last November, the Bank of Japan announced an expansion of its quantitative and qualitative monetary easing programme, but the effectiveness remains to be seen. Throughout last year, the myriad of factors contributed to the uncertainty and volatility of the financial markets. US interest rates went down instead of up during the year, defying market expectations; the US dollar strengthened sharply in the second half; equity markets in the US and Japan rallied, while those in Europe swung; oil prices plummeted by more than half in the second half; growth in emerging economies, including China, lost steam; and geopolitical tensions heightened. These developments, taken together, had made the macro environment more complex and uncertain.

In addition to a complicated global environment, Hong Kong had its own domestic challenges. Normal services in some bank branches were disrupted during the 79-day Occupy Movement. Despite this, the business continuity plans activated by the HKMA and by the affected banks operated smoothly and without incidents. The HKMA also stood ready to provide liquidity support to the banking system as and when needed. During the Occupy Movement, the local banking system and financial markets continued to function normally and the Hong Kong dollar exchange rate and interest rates remained stable, reflecting the strong market and public confidence in Hong Kong.

The Linked Exchange Rate System has been the cornerstone of Hong Kong's monetary and financial stability since its introduction in 1983. As a result of fund-raising and other commercial activities, a total of US\$9.7 billion equivalent of funds flowed into the Hong Kong dollar in July and August. The strong-side Convertibility Undertaking under the Currency Board system was repeatedly triggered, injecting Hong Kong dollar liquidity into the market to maintain exchange rate stability. The Hong Kong dollar softened in the fourth quarter. Throughout the year, there was ample liquidity in the interbank market, while the interbank rates remained largely steady, which provided a stable monetary environment for trading, commercial and other economic activities in Hong Kong.

The emergence of high-quality counterfeit HK\$1,000 banknotes in December 2013 and early 2014 aroused widespread public concern. The HKMA responded swiftly with multipronged measures that helped curb the further circulation of such counterfeit notes. Separately, we launched a two-year pilot Coin Collection Programme in September. Two coin collection carts served the 18 districts in Hong Kong on a rotation basis. The programme was very well received and at the end of 2014 had collected 46 million coins with a total face value of \$41 million from 50,000 persons.

2014 was also a challenging year for the HKMA in terms of banking supervision. Credit growth accelerated sharply at the beginning of the year before it moderated in the second half. Total loans for the year increased by 12.7%, compared with 16% in 2013. We took steps to further strengthen our supervision of banks' credit growth and asset quality. The Stable Funding Requirement, which came into effect from January 2014 and further refined in November, helped strengthen banks' liquidity management and mitigated the potential impact of financial market fluctuations on the banking system and the credit market. In view of the continued expansion of Mainland-related lending, the HKMA enhanced its supervisory capability through more comprehensive and granular reviews and analyses. At the same time, household indebtedness reached a record high of 64% of GDP on the back of rapid growth in personal loans. In this connection, we required banks to adopt more prudent risk management measures when underwriting personal loans, having regard to the potential default risks associated with interest rates rises. The property market became buoyant again in the second half of 2014, with notable increases in prices and transaction volumes compared with 2013, particularly in the small- and medium-sized residential units. To safeguard banking stability, the HKMA introduced the seventh round of countercyclical prudential measures at the end of February 2015 after closely monitoring developments in the property cycle and carefully assessing the potential impact on the banking sector. We will continue to carefully monitor the property market and will introduce appropriate countercyclical prudential measures.

We are also seeking to protect banking and financial stability through the enhancement of the legislative framework. Legislation for the second stage implementation of the Basel III requirements was enacted last year, introducing regulatory requirements on capital buffers and a liquidity coverage ratio for banks. To reduce the systemic risk posed by the "too big to fail" financial institutions, the HKMA joined hands with the Government, the Securities and Futures Commission and the Insurance Authority to consult the public and develop a piece of new legislation that creates a robust resolution regime for financial institutions that meets the latest international standards promulgated by the Financial Stability Board. Our aim is to introduce a bill into the Legislative Council before the end of 2015. We also sought to enhance the Deposit Protection Scheme in order to expedite the compensation payout process in the event of bank failures.

The HKMA has also been at the forefront in advocating financial consumer protection. For example, we took the initiative at the international level to promote greater transparency in "dynamic currency conversion" charges associated with overseas credit card spending. Our proposals were adopted by the task force under the Organisation for Economic Co-operation and Development (OECD) as one of the effective approaches for implementation of the G20 High-level Principles on Financial Consumer Protection. Separately, a series of publicity programmes promoting the "smart and responsible" use of banking services was also launched by the HKMA through different media channels during the year.

Chief Executive's Statement

2014 was a year of accomplishments in the development of offshore renminbi business in Hong Kong. The size of our renminbi liquidity pool, the total issuance of dim sum bonds, the amount of renminbi trade settlement handled by Hong Kong banks, and the turnover of the renminbi Real Time Gross Settlement (RTGS) system all reached record highs. The most important accomplishment of all was the launch of the Shanghai-Hong Kong Stock Connect in November, which was a major milestone for the liberalisation of the Mainland's capital account, creating further channels for the flow of renminbi between the onshore and offshore markets. At the same time, the daily renminbi conversion limit of RMB20,000 for Hong Kong residents was also removed, greatly facilitating the development of renminbi financial products in Hong Kong. To support the Shanghai-Hong Kong Stock Connect, the HKMA introduced an RMB10 billion intraday repo facility and designated seven banks as Primary Liquidity Providers. Both measures were designed to enhance the interbank liquidity and support market-making activities in the CNH market. All these accomplishments in 2014 further solidify Hong Kong's position as the premier global offshore renminbi hub.

Our efforts in developing Islamic finance in Hong Kong also bore fruit. The HKMA successfully launched the inaugural issuance by the HKSAR Government of US\$1 billion 5-year sukuk (Islamic bond), the world's first US dollar-denominated sukuk originated by an AAA-rated government. The issuance attracted strong demand from global investors with orders exceeding US\$4.7 billion and received a number of international awards.

On a number of occasions, I have argued that the competition among international financial centres is more a battle of soft power than hard infrastructure. The HKMA spares no efforts in Hong Kong's soft power in the financial arena. We continued to press ahead with the amendments to the Inland Revenue Ordinance to attract multi-national corporations to make Hong Kong their global or regional hub for corporate treasury centres. We sought to enhance banks' internal governance through their boards and directors. We also provided support to the banking industry in the development of the technical as well as ethical standards of its practitioners. For example, we joined hands with the Private Wealth Management Association to launch the Enhanced Competency Framework for private wealth management practitioners last June to establish standards for core competency and ongoing professional development.

As for hardware, our various critical financial market infrastructure, including the Hong Kong dollar, renminbi, US dollar and euro RTGS systems and the Central Moneymarkets Unit, continued to run extremely smoothly with total reliability. System developments for the over-the-counter derivatives trade repository are making good progress and it is being rolled out in phases. At the same time, in view of the latest advancement in financial technology and market developments, we have introduced a bill into the Legislative Council in February 2015 to establish a regulatory regime for stored value facilities and retail payment systems. We also planned to launch a brand new e-cheque service by the end of 2015 to provide a more convenient way to issue and deposit cheques through the internet and email system.

The Exchange Fund adopts a prudent asset allocation strategy that aims at capital preservation as well as stable returns in the medium to long run. The global investment environment in 2014 was exceptionally difficult. With the Federal Reserve starting to taper its asset purchases, it was widely expected that US interest rates would pick up gradually from the present low levels and the US dollar would strengthen gradually against other currencies. In view of these likely developments, we took several defensive moves, including holding more cash, reducing the average duration of our bond holdings, reducing the allocation to bonds in favour of equities and reducing our holdings in euro and yen. However, last year saw US interest rates go down instead of up and the US dollar index surge by a surprising magnitude, registering its steepest single-year rise in 17 years. As a result, the non-US dollar assets of the Exchange Fund incurred substantial exchange losses when translating into the US dollar, dragging down the Fund's overall investment return. The Exchange Fund recorded an investment income of \$44.7 billion in 2014 and an overall rate of return of 1.4%. The Investment Portfolio posted a return of 2% and the Long-Term Growth Portfolio achieved an annualised since-inception internal rate of return of 13.5%.

Looking ahead, we expect that the global macro environment and financial markets will become even more complicated and volatile than 2014. Asset markets around the world are jittery over the impending normalisation of US interest rates, but there are still significant uncertainties surrounding the timing and pace of the rate hikes. It is also difficult to discern the impact on global financial stability as a result of the normalisation of US interest rates amidst divergent monetary policy paths of major central banks. Therefore, fund flows, exchange rates, interest rates and asset prices will be highly unpredictable. Nevertheless, of all these uncertainties, one thing that is quite certain is the likely outflow of funds from emerging markets, including Hong Kong, when US interest rates enter the upward cycle and the US dollar continues to strengthen. In this cycle, financial and asset markets in Hong Kong, in particular the property market, will inevitably be affected. Emerging markets, including Mainland China, are likely to face further downward pressures, and the potential impact on Hong Kong cannot be underestimated. I and my colleagues in the HKMA will continue to tackle all these challenges and difficulties that may come our way with great care and a high degree of professionalism.



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 the responsibility to implement the decisions of the Hong Kong Deposit Protection Board, such as deciding whether compensation should be paid to the depositors of a failed scheme bank pursuant to the Ordinance.

THE HKMA AND THE HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT

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

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

The Financial Secretary, assisted by the Secretary for Financial Services and the Treasury, has responsibility for policies for maintaining the stability and integrity of

Hong Kong's financial system and the status of Hong Kong as an international financial centre. In support of these policies, the Monetary Authority's responsibilities include:

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

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

About the HKMA

ACCOUNTABILITY AND TRANSPARENCY

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

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

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

a policy of transparency and accessibility. This policy has two main objectives:

- to keep the financial industry and the public as fully informed about the work of the HKMA as possible, subject to considerations of market sensitivity, commercial confidentiality and statutory restrictions on disclosure of confidential information
- to ensure that the HKMA is in touch with, and responsive to, the community it serves.

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

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

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

ADVISORY AND OTHER COMMITTEES

Exchange Fund Advisory Committee

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

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

About the HKMA

EFAC is assisted in its work by five Sub-Committees, which monitor specific areas of the HKMA's work and report and make recommendations to the Financial Secretary through EFAC. The Committee held six meetings in 2014 to discuss the full range of issues relating to the work of the HKMA, most of which had been previously discussed by the relevant Sub-Committees.

The *Governance Sub-Committee* monitors the performance of the HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues. The Sub-Committee met five times in 2014 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 2014 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 2014 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 2014.

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 2014 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

Chairman



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

1 January 2015

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
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong



Mr Benjamin HUNG Pi-cheng, BBS, JP
Regional Chief Executive Officer, Greater China
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, SBS, 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

Advisory Committees



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



Mr Philip TSAI Wing-chung, JP
Vice Chairman
Deloitte China



Mr T. Brian STEVENSON, SBS, JP
(from 1 February 2014)



Mr Nicky LO Kar-chun, SBS, JP
(from 18 July 2014)

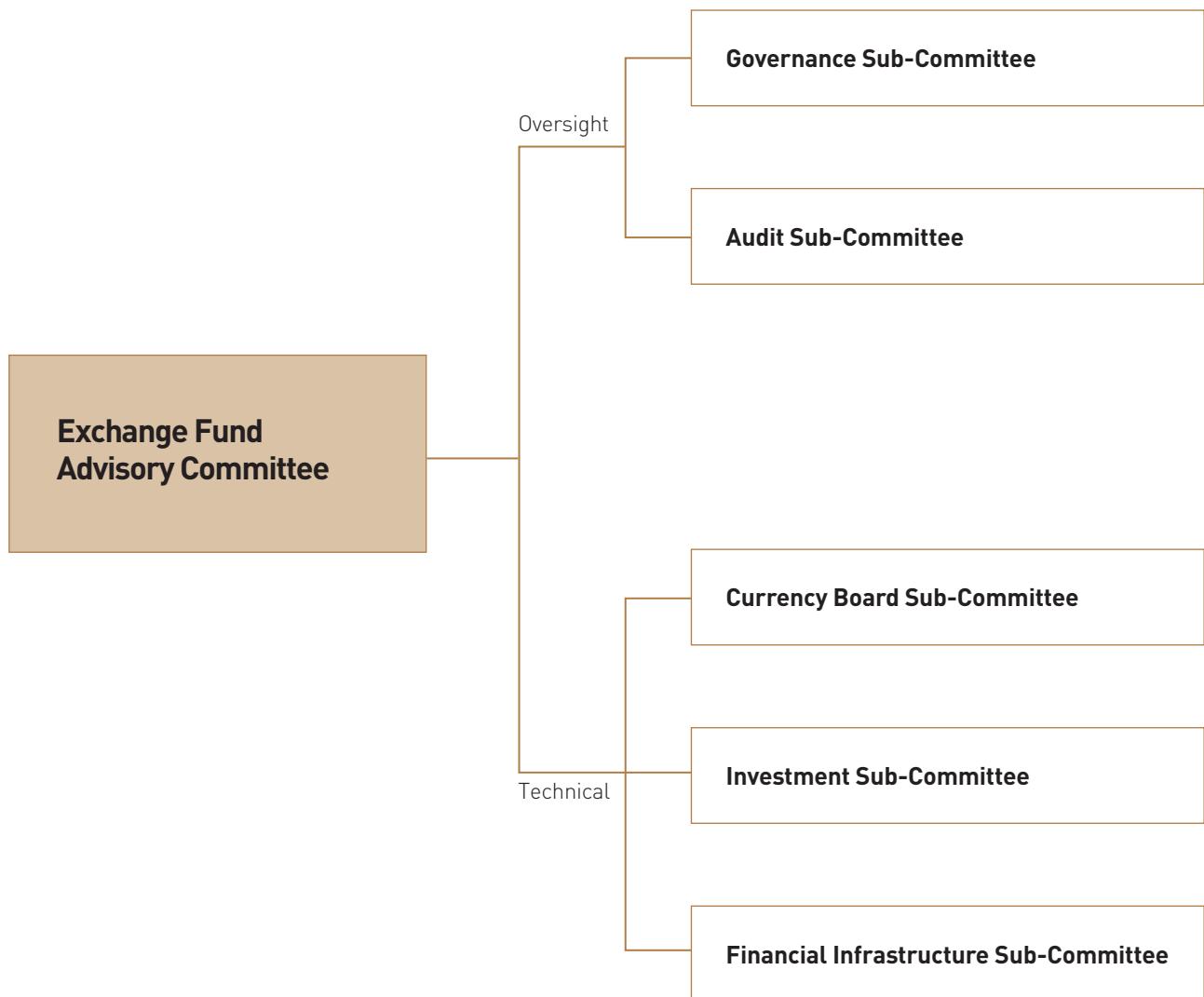


Dr John CHAN Cho-chak, GBS, JP
(until 31 October 2014)

Secretary

Mr Clement LAU

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
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

Members

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

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

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

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

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

Mr Nicky LO Kar-chun, SBS, JP
(from 18 July 2014)

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

Mr Carlson TONG, SBS, JP
Chairman
Securities and Futures Commission

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

Mr Philip TSAI Wing-chung, JP
Vice Chairman
Deloitte China

Mr T. Brian STEVENSON, SBS, JP
(from 1 February 2014)

Dr John CHAN Cho-chak, GBS, JP
(until 31 October 2014)

Secretary

Mr Clement LAU

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, SBS, JP

Chairman

Securities and Futures Commission

Members

Mr HE Guangbei, JP

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

Mr Philip TSAI Wing-chung, JP

Vice Chairman
Deloitte China

Mrs Angelina LEE WONG Pui-ling, SBS, JP

Partner

Woo, Kwan, Lee & Lo

Mr T. Brian STEVENSON, SBS, JP

(from 1 February 2014)

Mr Peter WONG Tung-shun, JP

Deputy Chairman and Chief Executive

The Hongkong and Shanghai Banking Corporation Limited
(until 31 January 2014)

Mr Benjamin HUNG Pi-cheng, BBS, JP

Regional Chief Executive Officer, Greater China
Standard Chartered Bank (Hong Kong) Limited
(until 31 December 2014)

Secretary

Mr Clement LAU

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
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

Dr PENG Wensheng
Global Chief Economist
Head of Research Department
CITIC Securities Company Limited

Ms Anita FUNG Yuen-mei, BBS
Chairperson
The Hong Kong Association of Banks
(from 1 January 2015)

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

Dr John GREENWOOD
Group Chief Economist
INVESCO Asset Management Limited

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

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

Professor Stephen CHEUNG Yan-leung, BBS, JP
President
The Hong Kong Institute of Education
(from 1 September 2014)

Mr HE Guangbei, JP
Chairperson
The Hong Kong Association of Banks
(until 31 December 2014)

Secretary

Mr Clement LAU

Terms of reference

- (1) To ensure that the operation of the Currency Board arrangements in Hong Kong is in accordance with the policies determined by the Financial Secretary in consultation with the Exchange Fund Advisory Committee.
- (2) To report to the Financial Secretary through the Exchange Fund Advisory Committee on the operation of the Currency Board arrangements in Hong Kong.
- (3) To recommend, where appropriate, to the Financial Secretary through the Exchange Fund Advisory Committee, measures to enhance the robustness and effectiveness of the Currency Board arrangements in Hong Kong.
- (4) To ensure a high degree of transparency in the operation of the Currency Board arrangements in Hong Kong through the publication of relevant information on the operation of such arrangements.
- (5) To promote a better understanding of the Currency Board arrangements in Hong Kong.

THE EXCHANGE FUND ADVISORY COMMITTEE INVESTMENT SUB-COMMITTEE

Chairman

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

Members

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

Mr 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

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

Mr T. Brian STEVENSON, SBS, JP
(from 5 December 2014)

Dr John CHAN Cho-chak, GBS, JP
(until 31 October 2014)

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

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

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

Mr Lester HUANG, JP
Managing Partner
P.C. Woo & Co.
(from 1 March 2014)

Mr Carlson TONG, SBS, JP
Chairman
Securities and Futures Commission
(until 28 February 2014)

Secretary

Mr Clement LAU

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

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

Mrs Ayesha MACPHERSON LAU, JP
Partner in Charge, Tax – Hong Kong SAR
KPMG

Ms DING Chen
Chief Executive Officer
CSOP Asset Management Limited
(from 20 October 2014)

Mr Lester HUANG, JP
Managing Partner
P.C. Woo & Co.
(until 28 February 2014)

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

Ms Anita FUNG Yuen-meい, 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

Mr Jack CHEUNG Tai-keung
Chief Executive Officer
Treasury Markets Association

Mr Vincent CHUI Yik-chiu
Chief Executive
Morgan Stanley Asia International Limited
(from 20 October 2014)

Mr Harold WONG Tsu-hing
Managing Director and Chief Executive
Dah Sing Banking Group Limited
(from 20 October 2014)

Professor Stephen CHEUNG Yan-leung, BBS, JP
President
The Hong Kong Institute of Education
(until 31 August 2014)

Secretary

Mr Clement LAU

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

Ms May TAN
Chief Executive Officer
Standard Chartered Bank (Hong Kong) Limited
Representing Standard Chartered Bank (Hong Kong) Limited
(from 12 July 2014)

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

Mr Carlson TONG, SBS, JP
Chairman
Securities and Futures Commission
Representing Securities and Futures Commission

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

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

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

Mr Toshihide MOTOSHITA
Executive Officer
Regional Head for Hong Kong and General Manager
The Bank of Tokyo-Mitsubishi UFJ, Limited
Hong Kong Branch
(from 1 December 2014)

Mr Benjamin HUNG Pi-cheng, BBS, 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
(until 11 July 2014)

Mr Hidekazu HORIKOSHI
Executive Officer
Regional Head for Hong Kong and General Manager
The Bank of Tokyo-Mitsubishi UFJ, Limited
Hong Kong Branch
(until 29 July 2014)

Secretary

Ms Jasmin FUNG

THE DEPOSIT-TAKING COMPANIES ADVISORY COMMITTEE

Chairman

The Honourable John TSANG Chun-wah, GBS, 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

Ms Joan HO Yuk-wai

Partner
Financial Services
KPMG

Ms Rebecca CHAN Sze-oi
Executive General Manager
Assets & Liabilities
Personal & Business Banking Group
China CITIC Bank International Limited
(from 1 December 2014)

Mr Vincent CHUI Yik-chiu

Chief Executive
Morgan Stanley Asia International Limited
(from 1 December 2014)

Mr LEE Huat-oon
General Manager/Chief Executive
Public Finance Limited
(until 30 November 2014)

Ms Miranda KWOK Pui-fong

President & Executive Director
China Construction Bank (Asia) Corporation Limited
(until 30 November 2014)

Secretary

Ms Jasmin FUNG

Chief Executive's Committee



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

1 January 2015



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)



Meena DATWANI, JP
Director-General (Enforcement)
(from 1 September 2014)



Carmen CHU, JP
Executive Director (Banking Conduct)
(from 1 September 2014)

Executive Director (External)
(until 31 August 2014)



Howard LEE, JP
Executive Director (Monetary Management)



Vincent LEE, JP
Executive Director (External)
(from 1 September 2014)



Henry CHENG, JP
Executive Director (Banking Supervision)

Chief Executive's Committee



Darryl CHAN, JP
Executive Director (Corporate Services)



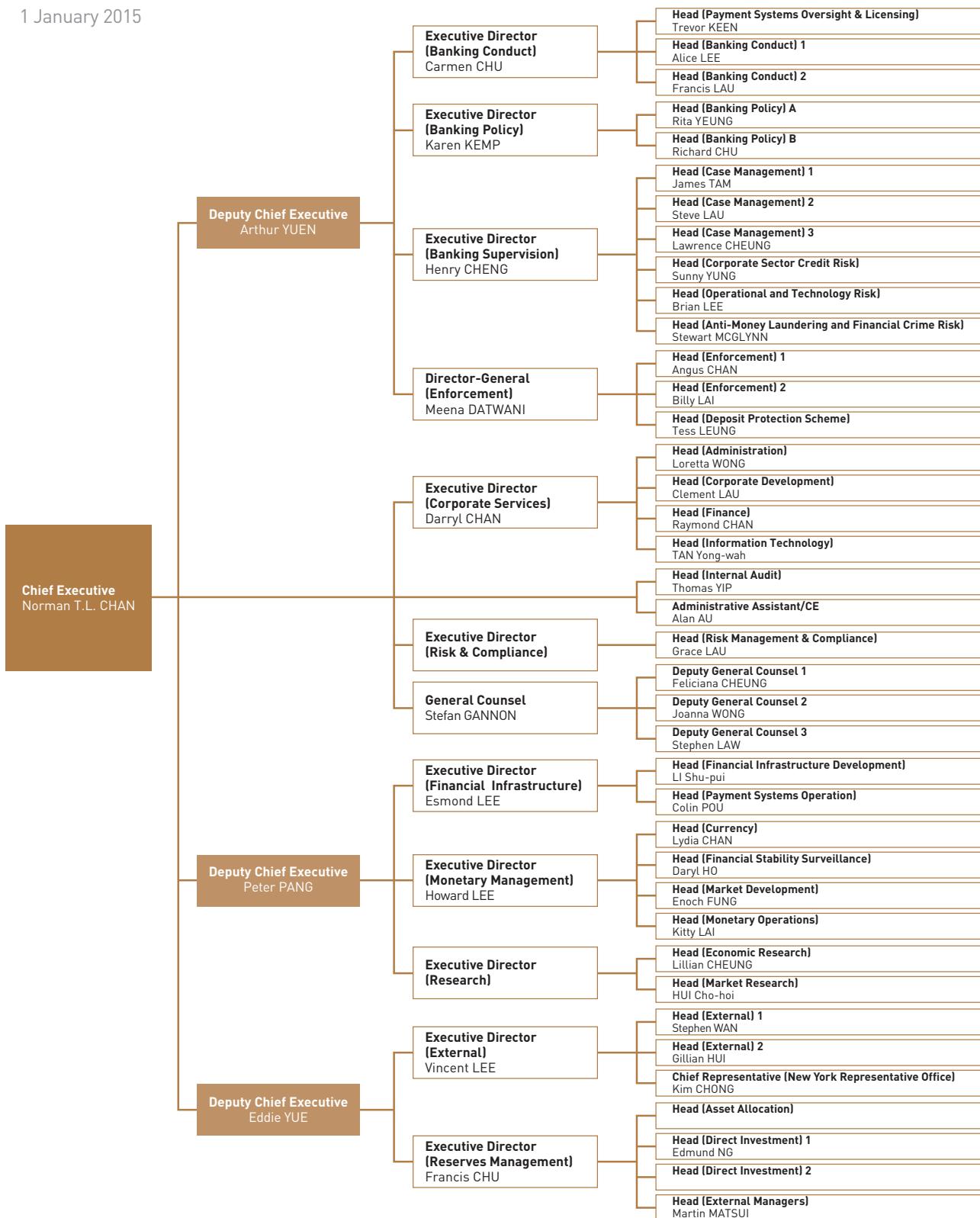
Raymond LI, JP
Chief Executive Officer
The Hong Kong Mortgage Corporation Limited



Dong HE, JP
Executive Director (Research)
(until 18 October 2014)

HKMA Organisation Chart

1 January 2015



Economic and Financial Environment

Hong Kong's economic growth momentum slowed in 2014 amid softer domestic demand and a weaker external trading environment. In 2015, economic growth is expected to remain moderate, although subject to risks relating to global growth prospects and monetary conditions.

THE ECONOMY IN REVIEW

Overview

The Hong Kong economy expanded at a slower pace in 2014, with real GDP growth slowing to 2.3% from 2.9% in 2013 (Chart 1 and Table 1). This mainly reflected milder growth in domestic demand, including softer private consumption and sluggish fixed investment activities. External trade performance remained weak, although in net terms its drag on GDP growth moderated. Despite

slower economic growth, labour market conditions remained broadly solid, with the unemployment rate staying low at 3.3%. Underlying consumer price inflation eased further with the feed-through of milder increases in housing rentals and modest business cost pressures. A host of global macro-financial factors caused some swings in the local stock market, while the property market turned more active, with housing prices picking up by 13.5% in 2014.

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) | 2014 | | | | | 2013 | | | | |
|--|-------------|-------------|-------------|-------------|-------------|------|------|------|-----|------|
| | Q1 | Q2 | Q3 | Q4 | 2014 | Q1 | Q2 | Q3 | Q4 | 2013 |
| Gross Domestic Product | 0.5 | -0.2 | 1.4 | 0.4 | 2.3 | 0.6 | 0.5 | 0.6 | 1.0 | 2.9 |
| (year-on-year growth) | 2.6 | 1.8 | 2.7 | 2.2 | | 3.2 | 2.8 | 2.8 | 2.8 | |
| Private consumption expenditure | 0.4 | 0.2 | 1.9 | 1.1 | 2.7 | 2.8 | 0.1 | -0.8 | 1.7 | 4.6 |
| Government consumption expenditure | 0.6 | 1.3 | 1.0 | 0.3 | 3.1 | 0.7 | 1.4 | 0.0 | 0.6 | 3.0 |
| Gross domestic fixed capital formation | - | - | - | - | -0.3 | - | - | - | - | 2.2 |
| Exports | | | | | | | | | | |
| Exports of goods | -2.5 | 0.7 | 1.8 | -0.3 | 1.0 | 2.3 | -1.3 | 2.8 | 1.4 | 6.5 |
| Exports of services | 0.2 | -1.6 | 0.2 | 0.6 | 0.5 | 0.8 | 3.9 | -2.9 | 2.4 | 4.9 |
| Imports | | | | | | | | | | |
| Imports of goods | -0.4 | -1.1 | 0.8 | 0.8 | 1.0 | 3.8 | -1.3 | 1.3 | 1.7 | 7.2 |
| Imports of services | -4.4 | 4.2 | -0.7 | 2.3 | 1.9 | 1.1 | -1.3 | 2.0 | 3.3 | 1.8 |
| Overall trade balance (% of GDP) | -1.2 | -6.2 | 5.8 | 1.3 | 0.1 | -2.4 | -6.5 | 6.5 | 3.5 | 0.6 |

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

The domestic money and foreign-exchange markets continued to function smoothly despite increased volatility in global financial markets and ongoing concerns about monetary policy paths in the major economies. The Hong Kong dollar exchange rate stayed near 7.75 against the US dollar for the better part of the year, and the strong-side Convertibility Undertaking was repeatedly triggered in July and August with strong inflows driven by commercial activities and equity-related demand. The Aggregate Balance increased markedly as a result, supporting the low interest rate environment locally. On the credit front, growth in total bank loans moderated to 12.7% in 2014 from 16.0% in 2013. The Hong Kong dollar loan-to-deposit ratio stabilised while the same ratio for the US dollar tapered off.

Domestic demand

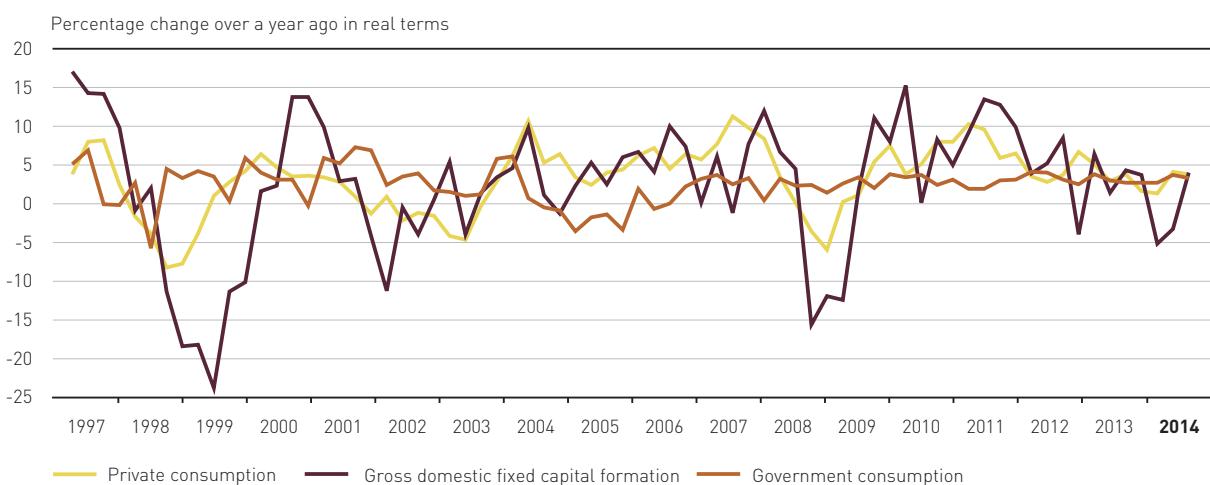
Domestic demand softened in 2014 (Chart 2). Before picking up somewhat in the second half of the year, growth in private consumption weakened in the first half, which brought down the full-year growth rate to 2.7% from 4.6% in 2013. While the still-favourable labour market conditions continued to render support, weaker economic prospects and slower increases in real incomes weighed on consumption growth. The drag on domestic demand

also came from a 0.3% decline in gross domestic fixed capital formation. In particular, amid cautious business sentiment, machinery and equipment acquisition in the private sector declined after three years of double-digit growth. On the other hand, building and construction activities increased, driven by robust housing projects and ongoing public infrastructure works.

External demand

Hong Kong's export performance remained sluggish in 2014 amid demand weakness in some major economies (Chart 3). Exports of goods increased by 1.0%, down from 6.5% in 2013. Reflecting the uneven growth in the advanced economies, demand from the US strengthened, while the EU and Japanese markets were lacklustre. Growth in exports to Mainland China slowed, despite support from intra-Asia trade driven to some extent by the launch of new smart-phones. Exports of services also moderated from a high growth path in earlier years, weighed mainly by a decline in tourist spending. Growth in imports of goods moderated along with softer domestic and export-induced demand, while imports of services progressed steadily. Taken together, net exports resulted in a modest negative contribution to GDP growth in 2014.

Chart 2 Domestic demand



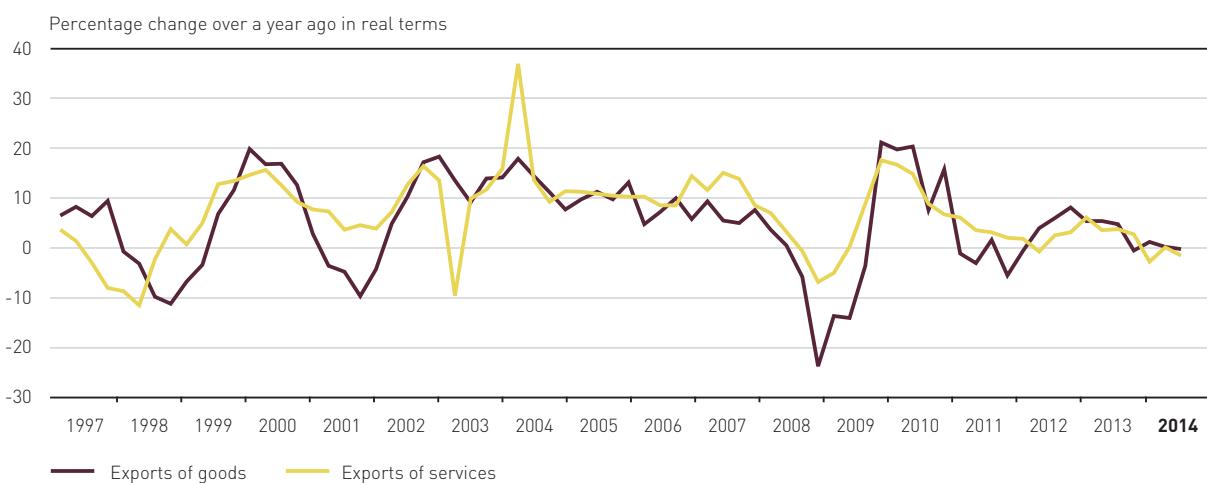
Source: Census and Statistics Department.

Inflation

Underlying inflation continued to moderate in 2014, mainly reflecting some easing in domestic cost pressures. After netting out the effects of the Government's one-off relief measures, the underlying inflation rate declined to 3.5% from 4.0% in 2013 (Chart 4). While food inflation held steady, the slower increase in fresh-letting housing rentals in earlier quarters continued to feed through. The

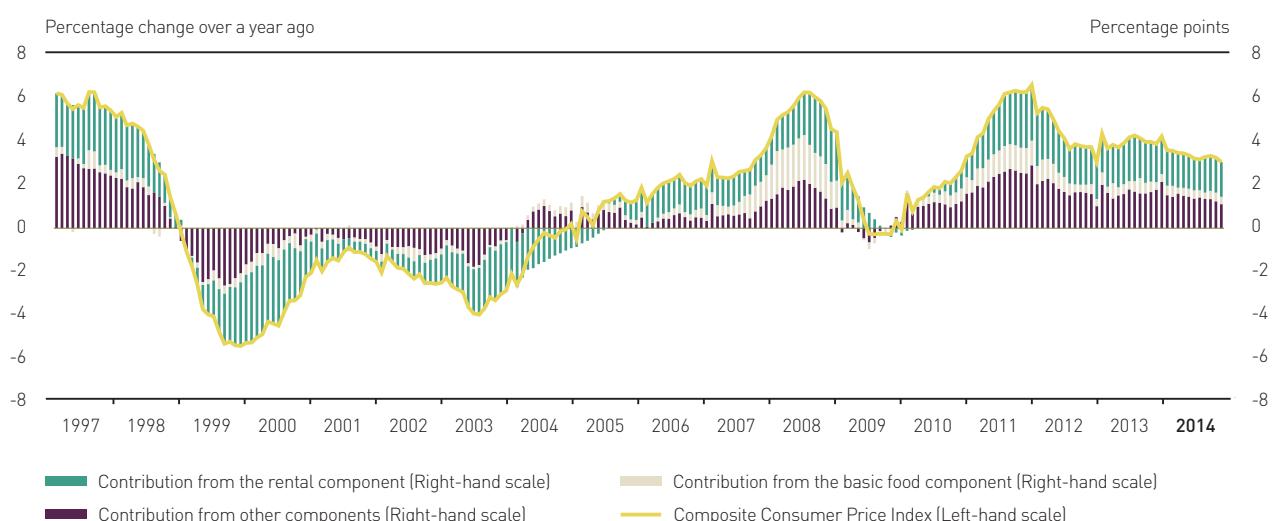
rise in other consumer price components also softened, led by a milder increase in the price of consumer goods and miscellaneous services. Overall, domestic cost pressures moderated, as shop and office rentals rose at a slower pace and labour cost increases remained steady. Import price pressure also eased amid the benign global commodity price environment.

Chart 3 Exports of goods and services



Source: Census and Statistics Department.

Chart 4 Underlying consumer price inflation



Source: Census and Statistics Department.

Economic and Financial Environment

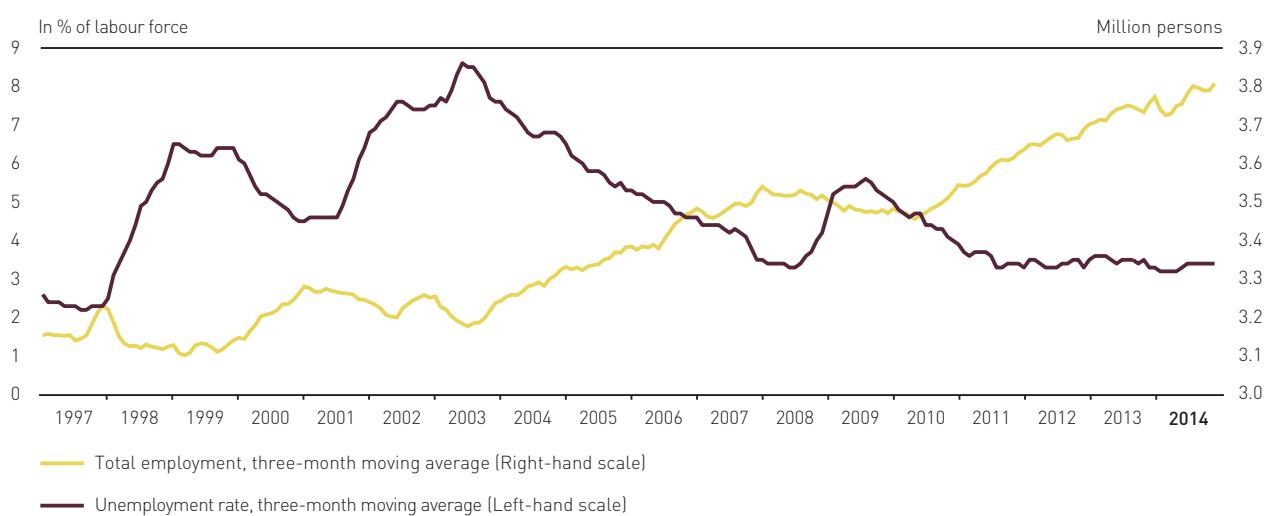
Labour market

While labour market conditions remained broadly stable in 2014, the overall demand for labour actually softened along with the slowdown in the Hong Kong economy. Total employment grew by a modest 0.6%, the slowest pace in four years. Corporate hiring sentiment also turned less optimistic, as shown in manpower demand surveys and the levelling off in job vacancy figures. On the other hand, labour supply increased mildly by 0.5% and broadly on par with the change in total employment. As a result, given the still-tight manpower resource balance, the seasonally adjusted unemployment rate was low at 3.3% in 2014 (Chart 5). Labour earnings rose moderately in nominal terms by 4.4% in the first three quarters of 2014 compared with 5.4% in 2013. After discounting for inflation, there was a real improvement of 0.2%, down from 1.0% in 2013.

Stock market

The Hong Kong stock market experienced a year of sharp fluctuations. Market performance was choppy early in 2014 because of concerns over the US Federal Reserve's tapering of its asset purchase programme and signs of a slowdown in Mainland China's economy. In the second quarter, market sentiment revived with the announcement of the Shanghai-Hong Kong Stock Connect, an improving US outlook and the Federal Reserve's accommodative monetary stance. Better-than-expected earnings of blue-chip corporations and robust equity fund flows also posted gains for the local stock market, with the Hang Seng Index reaching a six-year high in early September (Chart 6). However, the local stock market then underwent a sharp correction amid renewed concerns about global growth prospects and intensified geopolitical tensions. Increased

Chart 5 Labour market conditions



Source: Census and Statistics Department.

volatility on global financial markets and depreciation pressures on emerging-market currencies (in part triggered by a sharp decline in oil prices) also weighed on the local stock market. For the year as a whole, the Hang Seng Index rose by a modest 1.3%, compared with a 2.9% gain in 2013. Trading was active, particularly after the launch of the Shanghai-Hong Kong Stock Connect, while total funds raised from the local market surged to \$942.7 billion, compared with \$378.9 billion in 2013.

Property market

The residential property market turned more active after some consolidation in 2013. Housing prices picked up visibly from the second quarter onwards, leading to a cumulative increase of 13.5% in 2014, compared with 7.7%

a year earlier [Chart 6]. Trading activity also increased noticeably to a total of 63,807 units, up 25.9% from a record low in 2013, in part reflecting stronger sales in the primary market. Speculative transactions stayed at low levels, as shown in the number of confirmor transactions and short-term flipping trades. As income growth lagged behind the accelerated increase in housing prices, household affordability deteriorated further with the price-to-income ratio rising to a high of 14.8 and the income-gearing ratio deviating further above its long-term average.¹ Commercial and industrial property markets also revived, with prices and transaction volume broadly picking up. As rentals rose in tandem with prices, the rental yields saw little change and stayed near their historical lows.

Chart 6 Asset prices



Sources: Rating and Valuation Department, and Hong Kong Exchanges and Clearing Limited.

¹ The price-to-income ratio measures the average price of a typical 50 m² flat relative to the median annual income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio compares the amount of mortgage payment for a typical flat of 50 m² (under a 20-year mortgage scheme with a 70% loan-to-value ratio) with the median income of households living in private housing, from a potential home buyer's perspective. The income-gearing ratio is not the same as a borrower's actual debt-servicing ratio, which is subject to a maximum cap by the HKMA prudential measures.

Economic and Financial Environment

OUTLOOK FOR THE ECONOMY

Economic environment

Hong Kong's economic growth is expected to remain moderate in 2015. Slightly stronger global growth led by the US should provide moderate support for Hong Kong's export performance. Nevertheless, export growth is not likely to see a sharp turnaround as demand from the euro-zone and Japan remains weak, and growth in Mainland China and other emerging market economies is slowing. On the domestic front, private consumption should stay broadly resilient on the back of stable labour market conditions. Large-scale public infrastructure works and private building activities are also expected to hold up quite well, but the mixed business outlook and possible rises in interest rates in the future will likely continue to weigh on business capital investment. The Consensus Forecasts for Hong Kong's GDP growth project an average rate of 2.6%, while the Government forecasts growth in the range of 1-3%.

Inflation and the labour market

Inflationary pressures are anticipated to remain broadly contained in 2015. There should be further relief from external price pressures with the decline in international commodity prices and the resultant disinflationary dynamics. Domestically, labour cost increases will likely remain moderate, but a faster pick up in fresh-letting housing rentals in the second half of 2014 will gradually be reflected in the rental component of the consumer price index, thereby providing some offset. Private-sector analysts now expect the headline inflation rate to ease to 3.3% in 2015, while the Government sees the underlying inflation rate at 3%. The Consensus Forecasts for the unemployment rate are pitched at 3.4% for 2015, while survey results suggest that hiring sentiment is expected to remain broadly positive, despite a rather diverse outlook for different sectors of the economy.

Uncertainties and risks

The economic outlook for 2015 is subject to a number of uncertainties and risks. The divergence in growth and monetary policy paths in the advanced economies could lead to more volatile exchange rates, fund flows and global financial conditions, with potential negative spillovers to the Hong Kong economy through various financial channels. In particular, the timing and pace of US interest rate normalisation remain a major source of uncertainty. When the interest rate up-cycle sets in, monetary conditions in Hong Kong will inevitably tighten under the Linked Exchange Rate system and this in turn could weigh on real economic activities. Interest rate hikes could also dampen housing demand in Hong Kong and exert pressures on property prices. In case there is a sharp adjustment in the property market, the broader economy would also be affected, with repercussions on consumption and business investment. In addition, persistent strengthening of the US dollar, together with higher US interest rates, could increase the risk of a sudden re-pricing of risk assets and capital outflow pressures, as well as a rise in the debt servicing burden of borrowers of US dollar credit. The future path of oil prices also remains highly uncertain. In particular, sharp volatilities in oil prices could put some oil-exporting countries and energy producers under financial and credit stress, with possible contagion risks to global financial markets.

PERFORMANCE OF THE BANKING SECTOR

The Hong Kong banking sector remained resilient during the year, despite the economic slowdown in some major economies, and uncertainties over the timing and pace of interest rate rises by the US Federal Reserve following the end of its unprecedented quantitative easing programme. The asset quality and liquidity positions of retail banks remained sound, and locally incorporated authorized institutions continued to be well capitalised. Credit growth in the banking sector slowed in the second half of the year.

Interest rate trends

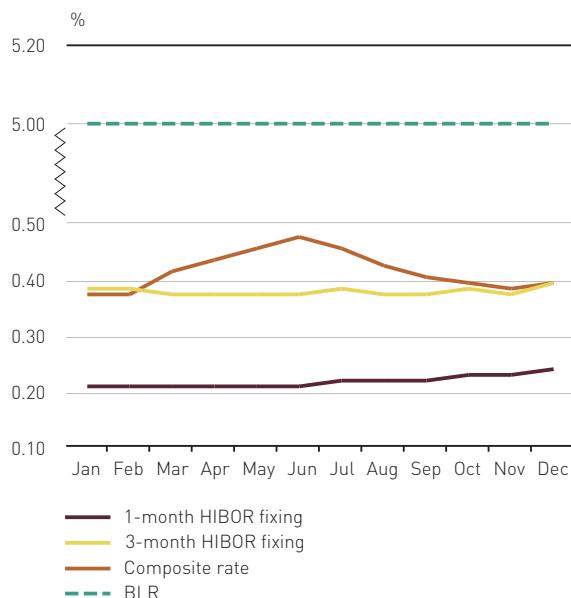
In line with the US dollar interest rates, Hong Kong dollar interbank interest rates remained relatively low throughout the year. It is worth noting that the funding

costs of retail banks steadily declined after reaching a recent high in June 2014, as indicated by a downward trend in the composite interest rate since then (Chart 7).

Profitability trends

The profitability of the banking sector remained relatively stable in 2014. The aggregate pre-tax operating profits of retail banks' Hong Kong offices registered a modest growth of 3.6% as the 14.0% growth in net interest income was partly offset by a 9.1% increase in operating costs and a 2.1% reduction in non-interest income. As a result of the combined effects of the growth in average assets and a reduction in post-tax profit (mainly due to a drop in extraordinary profit), the post-tax return on the average assets of retail banks dropped to 1.0% in 2014 from 1.4% 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



Economic and Financial Environment

Retail banks' net interest margin remained stable at 1.40% in 2014, unchanged from a year ago [Chart 9].

Driven by a decrease in income from foreign exchange and derivatives operations, but partly offset by the growth in income from fees and commissions, retail banks' non-interest income as a share of total operating income decreased to 43.0% from 46.8% in 2013.

The operating costs for retail banks increased by 9.1%, largely caused by rising staff expenses. As the growth in operating costs outpaced that of operating income, the cost-to-income ratio increased to 43.5% in 2014 from 42.4% in 2013 [Chart 10].

The net charge for debt provisions rose to \$4.8 billion from \$3.6 billion in 2013. Despite the increase, the bad debt charge to average assets was still at a low level of 0.05%, reflecting the sound quality of retail banks' loan book.

Chart 9 Retail banks' net interest margin

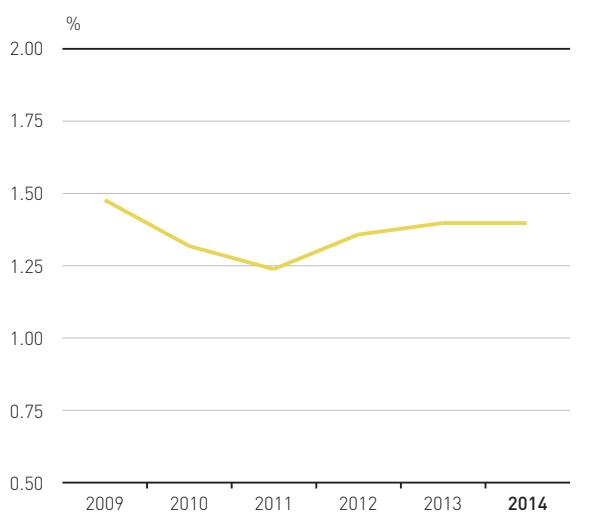
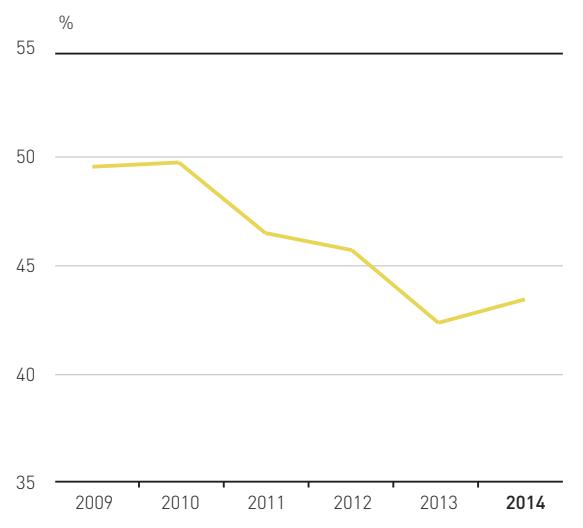


Chart 10 Retail banks' cost-to-income ratio



Asset quality

The asset quality of retail banks remained sound during the year. The classified loan ratio slightly reduced to 0.45% at the end of 2014 from 0.48% a year earlier. The combined ratio of overdue and rescheduled loans also dropped to 0.29% from 0.33% during the same period (Chart 11).

The quality of surveyed institutions' residential mortgage lending remained good, with the delinquency ratio of 0.03% at the end of 2014 (Chart 12). The rescheduled loan ratio was unchanged at nearly 0%. The surveyed institutions

reported no case of residential mortgage loans in negative equity at the end of the year, compared with 26 cases at the end of 2013.

The credit card portfolios' delinquency ratio and the combined delinquent and rescheduled ratio were kept at a low level of 0.20% and 0.27% respectively at the end of 2014 (Chart 12). Both ratios remained unchanged compared with a year ago. The charge-off ratio edged down to 1.83% from 1.84% in 2013.

Chart 11 Asset quality of retail banks

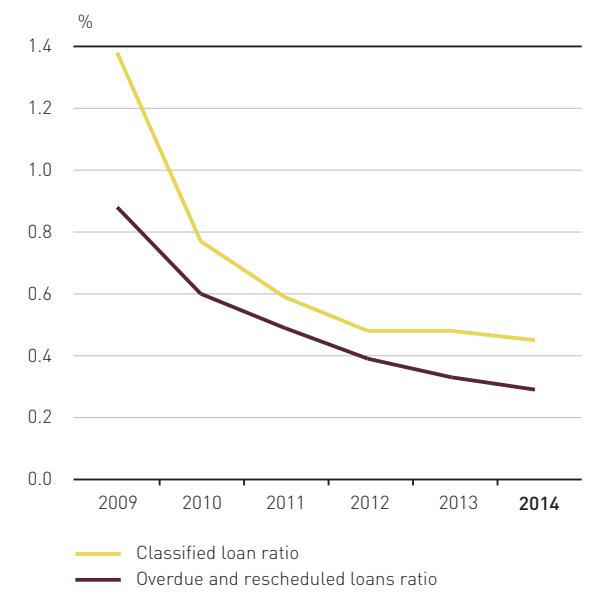
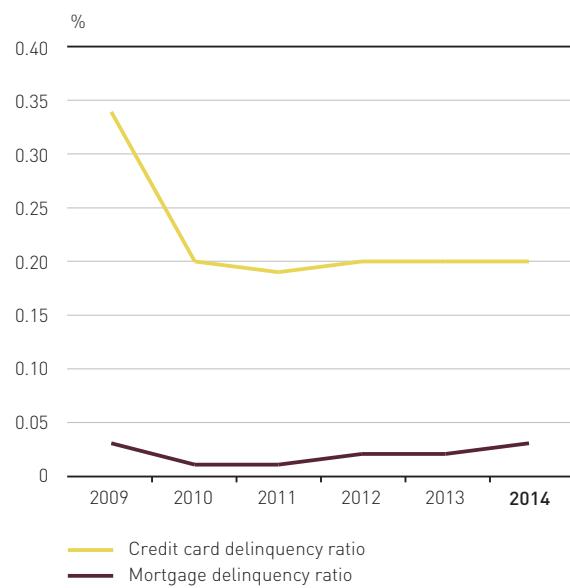


Chart 12

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 12.0% in 2014, while total deposits rose by 9.6%. As a result, the overall loan-to-deposit ratio of retail banks increased to 57.5% from 56.2% at the end of 2013. The Hong Kong dollar loan-to-deposit ratio edged down to 74.6% from 74.8% during the same period (Chart 13).

Credit growth in the banking sector slowed from 16.0% in 2013 to 12.7% in 2014. The rate of growth in loans for use outside Hong Kong continued to outpace that for use in Hong Kong. The increase in loans for use in Hong Kong was mainly for property lending, loans to financial concerns, as well as electricity and gas.

The banking sector's Mainland-related lending continued to expand in 2014. Total Mainland-related lending² increased to \$3,117 billion at the end of 2014 from \$2,616 billion a year ago.

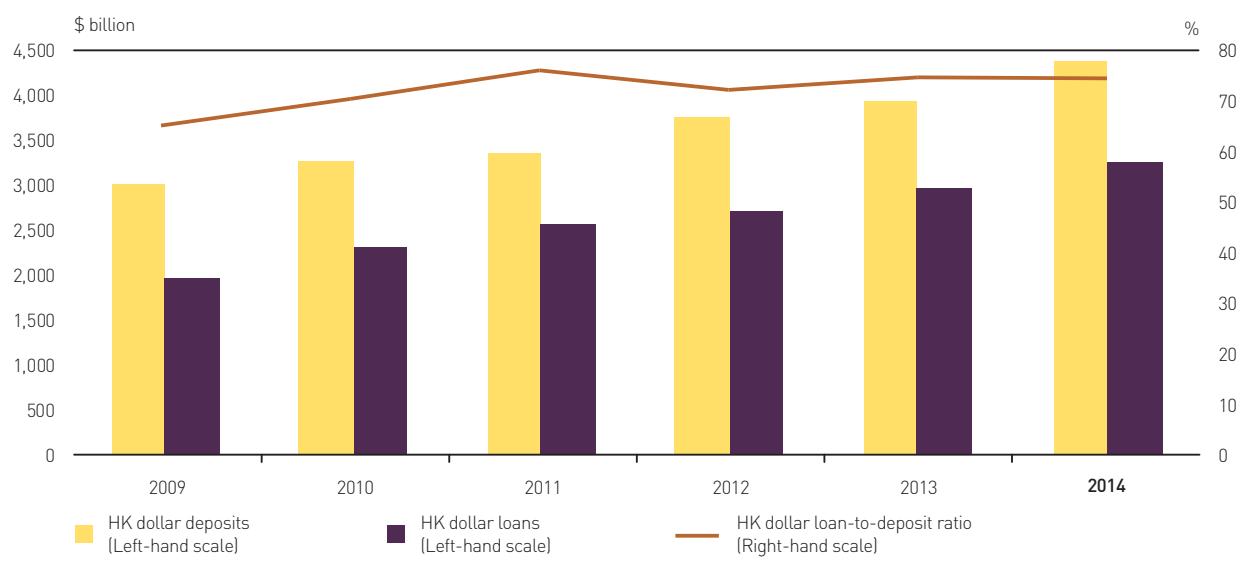
Holdings of negotiable debt securities

Retail banks' holdings of negotiable debt instruments (NDIs), excluding negotiable certificates of deposit, decreased by 3.9% in 2014. The share of total holdings of NDIs relative to total assets decreased to 22% at the end of the year from 25% at the end of 2013. Among the holdings of NDIs, 47% were government-issued (43% in 2013), 31% were issued by non-bank corporations (28% in 2013), and 22% were issued by banks (29% in 2013) (Chart 14).

Capital adequacy and liquidity

All locally incorporated authorized institutions remained well capitalised. Their consolidated capital adequacy ratio rose to 16.8% at the end of 2014 from 15.9% at the end of 2013 (Chart 15). This was due to faster growth in the capital base than in the risk-weighted amount. During the same period, the Tier-1 capital adequacy ratio also increased to 13.9% from 13.3%.

Chart 13 Retail banks' Hong Kong dollar loans and deposits



² Including loans booked in locally-incorporated banks' banking subsidiaries in Mainland China.

The liquidity ratio of the retail banks was maintained at a comfortable level in 2014. The average liquidity ratio increased from 39.6% in the final quarter of 2013 to 41.1% in the same period of 2014 because the average liquefiable assets rose faster than the average qualifying liabilities (Chart 16). As the Banking (Liquidity) Rules came into effect on 1 January 2015, authorized institutions in Hong Kong began implementing the new liquidity requirements under Basel III, with their liquidity being measured by the Liquidity Coverage Ratio and the Liquidity Maintenance Ratio.

Chart 14

Retail banks' holdings of negotiable debt instruments at the end of 2014 (issuer breakdown)

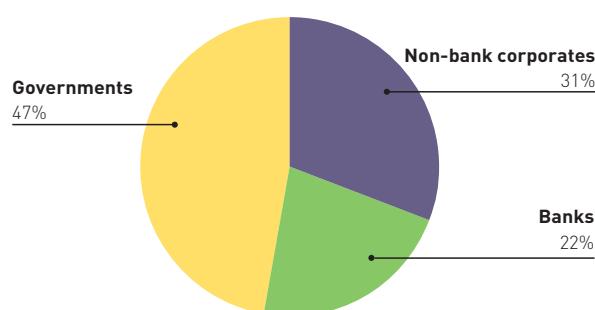


Chart 15

Consolidated capital adequacy ratio of locally incorporated AIs

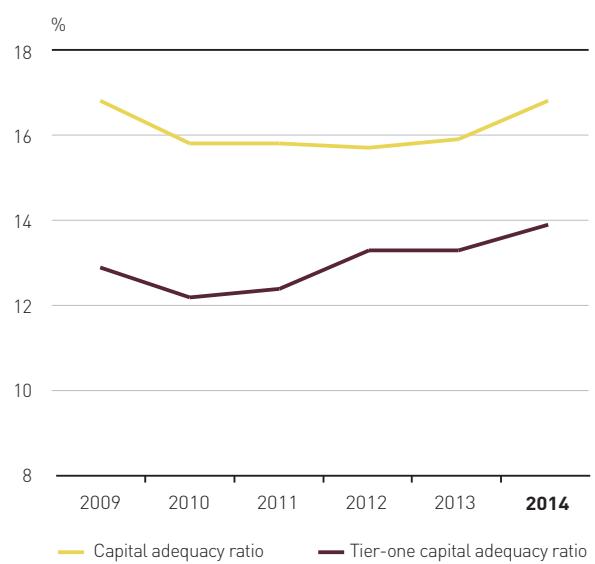
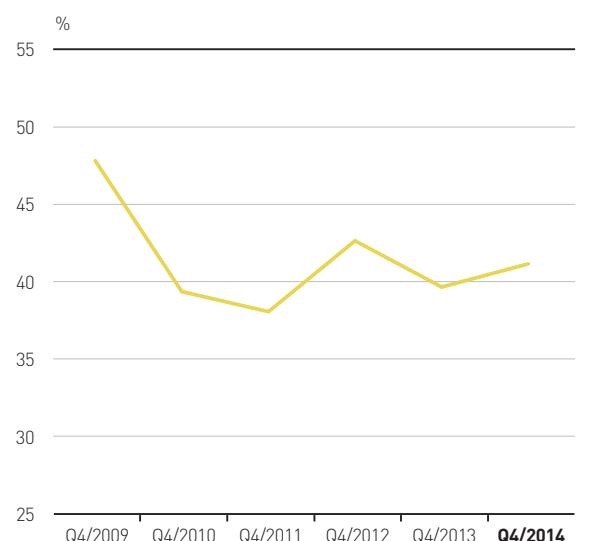


Chart 16

Retail banks' liquidity ratio (quarterly average)



PROSPECTS FOR 2015

The divergence in the monetary policies of the major developed economies has increased the uncertainties in the global financial market and the overall economic outlook. The US Federal Reserve is expected to raise its interest rate, but the timing and pace of the rise remain uncertain. In Europe and Japan, the European Central Bank and the Bank of Japan have further expanded their asset purchase programmes. These developments are causing considerable uncertainty for global fund flows and liquidity conditions. At the time of writing this Report, there had been no noticeable impact on Hong Kong's banking sector. Nevertheless, banks have been reminded 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.

Monetary Stability

The Hong Kong dollar exchange rate traded in an orderly manner in 2014 despite volatile global financial markets. Hong Kong's money market continued to function normally with ample liquidity. The Linked Exchange Rate system has proved highly resilient to external shocks and continued to serve as the anchor for Hong Kong's monetary and financial stability.

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\$. 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 2014 | 31 December 2013 |
|--|------------------|------------------|
| Certificates of Indebtedness ¹ | 342,165 | 329,325 |
| Government-issued currency notes and coins in circulation ¹ | 11,092 | 10,638 |
| Balance of the banking system | 239,183 | 164,093 |
| Exchange Fund Bills and Notes (EFBN) issued ² | 753,546 | 751,850 |
| TOTAL | 1,345,986 | 1,255,906 |

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

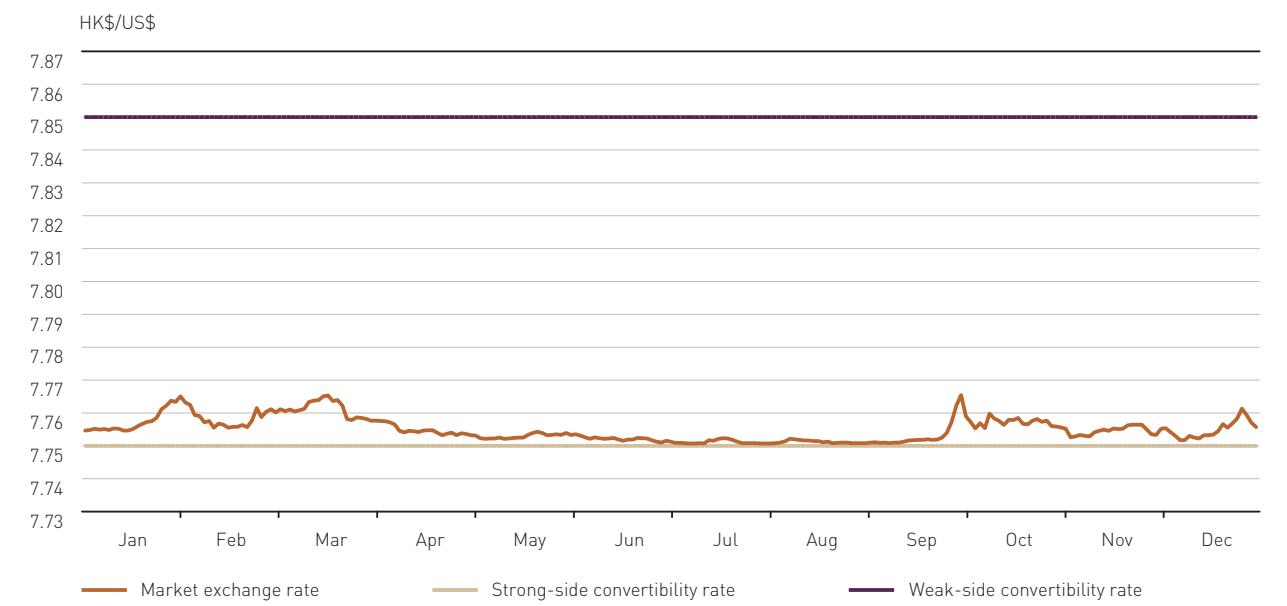
REVIEW OF 2014

Exchange-rate stability

The Hong Kong dollar exchange rate traded within a narrow range between 7.7500 and 7.7657 against the US dollar, while activities in the local foreign exchange market remained orderly throughout the year (Chart 1). In the early part of 2014, the Hong Kong dollar softened slightly, in part reflecting weaker equity-related demand due to concerns about the tapering of asset purchases by the US Federal Open Market Committee and weaker growth prospects for Mainland China's economy. From April onwards, the Hong Kong dollar exchange rate strengthened and stayed close to 7.75. In particular, the strong-side CU was triggered repeatedly in July and

early August, prompting the HKMA to passively purchase a total of US\$9.7 billion from banks in exchange for HK\$75.3 billion. This led to a corresponding increase in the Aggregate Balance in accordance with the Currency Board principles. The strengthening of the Hong Kong dollar during this period was largely underpinned by equity-related demand and strong commercial demand arising from dividend distributions and cross-border merger and acquisition transactions. In the fourth quarter, the Hong Kong dollar exchange rate softened modestly amid the broad strength of the US dollar and repatriation abroad of equity fund-raising proceeds. Currency stability of the Hong Kong dollar remained intact despite increased volatility on global financial markets and depreciation pressures in emerging-market currencies in December.

Chart 1 Market exchange rate in 2014



Money market

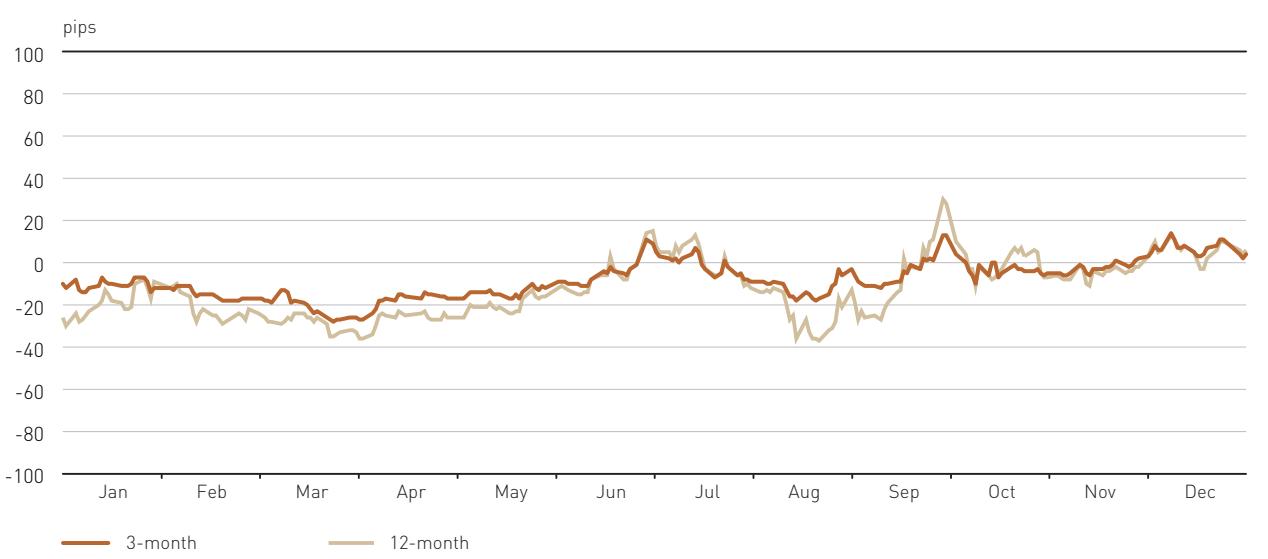
The Hong Kong dollar interbank interest rates continued to stay at low levels in 2014 (Chart 2). There were intermittent fluctuations due to increased demand for equity funding and banks' liquidity needs prior to the end of each quarter and holiday seasons. The Hong Kong dollar forward points narrowed gradually and turned occasionally from discounts to small premiums, broadly consistent with the movements in the Hong Kong Interbank Offered Rate

(HIBOR) — London Interbank Offered Rate (LIBOR) spreads (Chart 3). This partly reflected an increase in banks' liquidity needs, with some interbank participants tapping Hong Kong dollar funding in the swap market through collateralised term funding. Overall, the money market operated smoothly and without disorderly adjustments. The short-term interbank interest rate remained well below the Base Rate of 0.5%. Discount Window borrowing was not active and amounted to \$1.9 billion in 2014.

Chart 2 Hong Kong dollar interbank interest rates in 2014



Chart 3 Hong Kong dollar forward points in 2014



Monetary Stability

The Linked Exchange Rate system

The Linked Exchange Rate system (LERS) has served Hong Kong well since 1983 as the anchor for monetary and financial stability and has proved to be highly resilient in a series of regional and global financial crises. The Hong Kong SAR Government is firmly committed to the LERS, which continues to best suit Hong Kong as a small and open economy and an international financial centre. Stability in the foreign exchange and money markets further reinforces the credibility of the Government's commitment to the System. There is also continued strong public confidence in the Hong Kong dollar as a means of payment and storage of value. In addition, the International Monetary Fund (IMF) strongly endorsed the LERS in its Financial Sector Assessment Program (FSAP) and the 2014 Article IV consultation with Hong Kong, describing it as a credible, transparent, and effective exchange rate regime which, combined with robust and proactive financial supervision and regulation, prudent fiscal management, and flexible markets, has worked well to help Hong Kong successfully weather changing global conditions.

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

Since October 1998, a specific portion of the Exchange Fund's assets has been allocated to back the Monetary Base to improve the transparency of the Currency Board Account. The Backing Ratio (defined as the Backing Assets divided by the Monetary Base) moved within a narrow range of 107-108% during 2014, without touching the Upper or Lower Trigger Level. The ratio closed at 107.3% on 31 December 2014 (Chart 4). 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 under the LERS. 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 2014



Other Activities

The Exchange Fund Advisory Committee (EFAC) Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2014, the Sub-Committee considered issues including monetary policy normalisation in the US, developments in capital flows in East Asia, shadow banking in Mainland China, and the streamlining of the Exchange Fund Bills and Notes Programme and the Government Bonds Programme. Records of the Sub-Committee's discussions and the reports on Currency Board operations submitted to the Sub-Committee are published on the HKMA website.

The Hong Kong Institute for Monetary Research (HKIMR) continued to sponsor research in the fields of monetary policy, banking and finance. In 2014, the Institute hosted 20 research fellows, published 32 working papers and one occasional paper.

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

- The Fifth Annual International Conference on the Chinese Economy in January, which focused on "Price Reforms and Factor Markets Liberalisation in the Chinese Economy". Eight high quality research papers were presented covering a wide range of issues, including bank competition in China, interest rate determination, capital account liberalisation, labour productivity and regulation, China's economic transition, and renminbi internationalisation.
- The HKMA and the Federal Reserve Bank of New York joint conference in March on "Domestic and International Dimensions of Unconventional Monetary Policy". This conference brought together economists from academia and central banks to review and assess theoretical and empirical aspects of unconventional monetary policies, such as asset purchases, quantitative and credit easing, forward guidance on

the policy rate path, funding for lending schemes and related interventions. The conference also featured a speech by Professor Chris Sims (2011 Nobel Laureate in Economics) entitled "Do Central Bank Balance Sheets Matter?"

- The HKIMR, the Institute for New Economic Thinking (INET), and the Centre for International Governance Innovation (CIGI) joint conference on "China and the World Economy: Trade and Financial Linkages" in June. This conference covered topics including China's influence in global trade, China's role in the global commodities market, interest rate liberalisation, monetary policy framework, renminbi internationalisation, and China's capital account liberalisation.
- The Fourth Annual Meeting of the Asian Central Banks Watchers Group organised jointly with the Official Monetary and Financial Institutions Forum (OMFIF) in December, with the theme "Internationalisation of the Renminbi: Implications for World Finance". The conference examined a wide range of issues relating to the renminbi, including the growing importance of its internationalisation for the world economy, its role in international reserves management and other official sector financial transactions, its role in international capital markets, trade financing and investment, and the future challenges and opportunities for renminbi internationalisation.

The Institute also hosted its 12th HKIMR Summer Workshop in August, and the 12th HKIMR Conference on the Mainland Economy on shadow banking and financial innovation in China. The conferences and workshops were attended by participants from academia, the financial services industry and global central banks. In addition, the Institute held 33 public seminars during the year covering a broad range of economic, monetary and financial issues.

Monetary Stability

Notes and coins

At the end of 2014, the total value of banknotes in circulation was \$342.2 billion, an increase of 3.9% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to \$10.9 billion, up 4.4% (Charts 8 and 9). The value of the government-issued \$10 notes in circulation reached \$3.9 billion, of which 77% are polymer notes.

Chart 5

Banknotes in circulation by note-issuing banks at the end of 2014

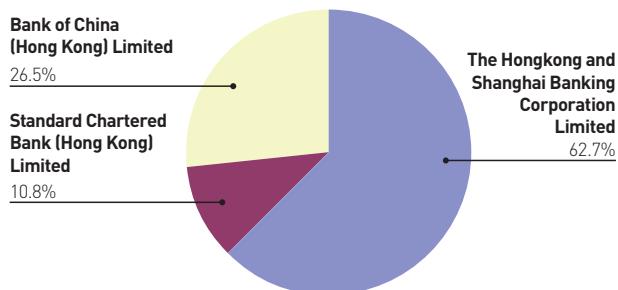
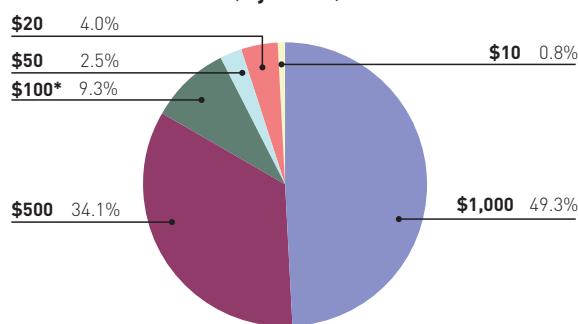


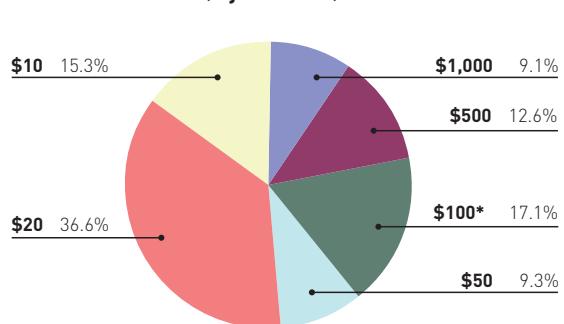
Chart 6

Distribution of banknotes in circulation at the end of 2014

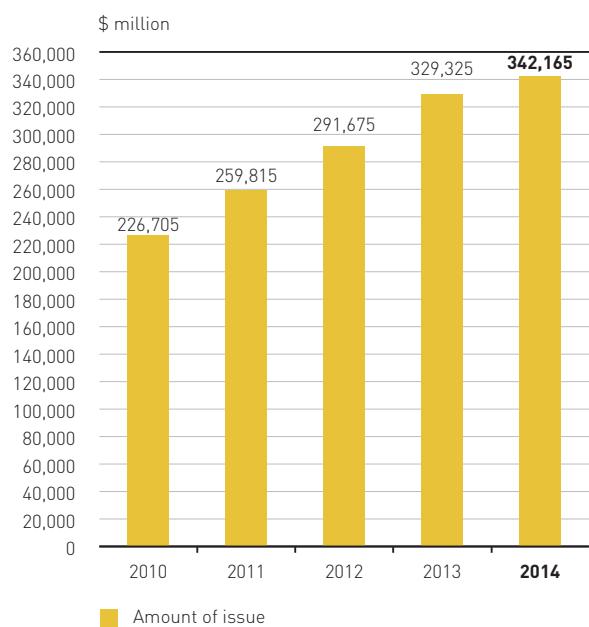
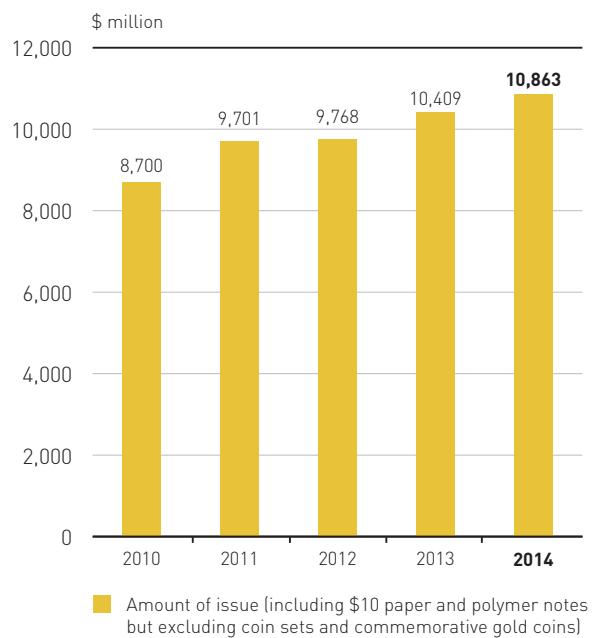
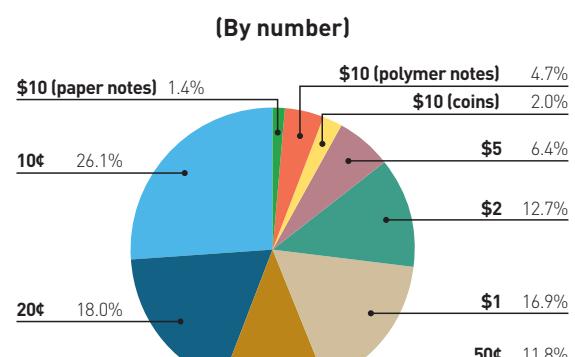
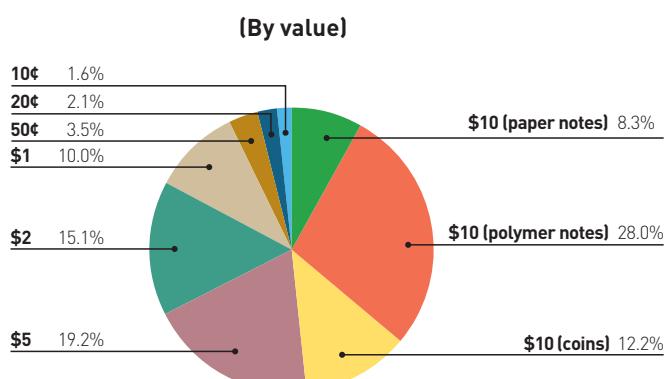
(By value)



(By number)



* Includes 0.1 percentage point contributed by \$150 banknotes.

Chart 7 Banknotes in circulation at the end of 2014**Chart 8** Government-issued notes and coins in circulation at the end of 2014**Chart 9** Government-issued notes and coins in circulation at the end of 2014

Monetary Stability

Hong Kong banknotes

Some high quality counterfeit notes of the 2003 series \$1,000 banknote first surfaced in December 2013. The HKMA responded swiftly with a series of publicity programmes and education seminars on how to identify the counterfeit notes, as well as other contingency measures such as replacement or recalibration of cash deposit machines. The number of these fake notes seized by the Police subsequently fell quickly and fewer than 500 pieces were found up to the end of 2014. Banks also expedited the replacement of the 2003 series with the 2010 series, which incorporates more advanced security features.

The Hong Kong currency remains one of the most secure against counterfeiting. The total number of counterfeit notes found in 2014 was less than one piece per one million banknotes in circulation, which is very low by international standards. As public knowledge is the best defence against counterfeiting, the HKMA continued its public education campaign to promote awareness of the design and security features of Hong Kong's banknotes. During the year, it held 55 seminars on how to authenticate banknotes for over 11,000 participants, including bank tellers, retailers and students.

Coin Collection Programme

In September, Hong Kong launched the world's first structured coin collection scheme using a mobile approach under a two-year pilot Coin Collection Programme. The

Programme provides a way for members of the public to get value for their surplus coins in addition to the existing banking system. The coins collected will be re-circulated to meet public demand, making circulation more efficient and reducing the need for minting new coins.

Two collection vehicles, known as "Coin Carts", collect coins from the public in all 18 districts in Hong Kong on a rotational basis and free of charge. Each vehicle is equipped with two high-speed coin counting machines, and an electric wheelchair lift. There are also operational staff stationed at the vehicles to provide assistance. Users can choose to exchange their spare coins for banknotes or add value to their Octopus cards. A Community Chest donation box is also inside each vehicle. The exterior design of the Coin Carts was chosen from the winner of the "Mobile Coin Collection Kiosk Design Competition" among secondary school students. The two-year pilot Coin Collection Programme runs until September 2016, when it will be subject to review.

The programme has been well received by the public and is considered an innovative and environmentally-friendly scheme to enhance the circulation of coins. From its start in early October to the end of 2014, the two Coin Carts had served 50,000 people, collecting 46 million coins with a total face value of \$41 million. Further details of the programme and up-to-date information, including the service schedule of the Coin Carts, are available on a designated page on the HKMA website (coincollection.hkma.gov.hk).



Chief Executive of the HKMA, Mr Norman Chan, presents a certificate to the winner of the "Mobile Coin Collection Kiosk Design Competition", Wong Yiu-man, from Shun Tak Fraternal Association Tam Pak Yu College.



Two Coin Carts collect coins from the public at Upper Ngau Tau Kok Estate.

Exchange Fund Bills and Notes

The HKMA announced in December that the issuance of Exchange Fund Notes and Government Bonds would be streamlined to minimise overlap in the longer tenors and to establish a single benchmark yield curve. Starting from January 2015, new issuance of Exchange Fund Notes with tenors of three years or above will cease. Maturing Exchange Fund Notes of those tenors will be replaced by additional Exchange Fund Bills to maintain the overall size of Exchange Fund paper. At the same time, new issuance of two-year Government Bonds will cease and the new issuance of Government Bonds will confine to tenors of three years and above. The amount of these new issuances of Government Bond will be suitably increased to meet investors' demand for longer term high-quality Hong Kong dollar bonds. At the end of 2014, the amount of outstanding Exchange Fund paper stood at \$752.6 billion (Table 2).

PLANS FOR 2015 AND BEYOND

The global macro-financial environment is expected to be challenging in 2015 in view of the uncertain and divergent monetary policies of the major advanced economies. The

US Federal Reserve is expected to raise policy rate but the timing and pace remained uncertain. Meanwhile, other major central banks, including the European Central Bank and the Bank of Japan have embarked on further monetary easing. On the whole, it is likely that monetary conditions across the globe, including Hong Kong, will remain accommodative in the short term. However, as the Federal Reserve starts raising the policy rate, monetary conditions in Hong Kong will inevitably tighten under the LERS, and while the outcome is far from clear, fund flows could be more volatile and asset prices under greater pressure.

The HKMA will continue to closely monitor risks and vulnerabilities in the domestic and external environment and stands ready to deploy appropriate measures if necessary to maintain Hong Kong's monetary and financial stability. Research programmes in 2015 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 enhance them.

Table 2 Outstanding issues of Exchange Fund Bills and Notes

| \$ million | 2014 | 2013 |
|--|----------------|---------|
| Exchange Fund Bills (by original maturity) | | |
| 28 days | 0 | 0 |
| 91 days | 400,730 | 399,851 |
| 182 days | 241,000 | 241,000 |
| 364 days | 42,200 | 42,200 |
| Sub-total | 683,930 | 683,051 |
| | | |
| Exchange Fund Notes (by remaining tenor) | | |
| 1 year or below | 14,900 | 15,800 |
| Over 1 year and up to 3 years | 25,600 | 25,300 |
| Over 3 years and up to 5 years | 11,200 | 11,200 |
| Over 5 years and up to 10 years | 11,000 | 9,800 |
| Over 10 years | 6,000 | 6,000 |
| Sub-total | 68,700 | 68,100 |
| | | |
| Total | 752,630 | 751,151 |

Banking Stability

In 2014, the HKMA focused its supervisory efforts on authorized institutions' (AIs) credit risk and liquidity risk management, Mainland China-related lending, anti-money laundering controls, and the selling practices for investment and insurance products. In banking developments, the second phase of Basel III capital standards and the Basel III Liquidity Coverage Ratio were implemented. The HKMA completed a public consultation on enhancing the Deposit Protection Scheme and, to help promote AIs' customer-centric culture and capacity building, undertook various initiatives to ensure appropriate development for bank directors. And the enhanced competency framework for private wealth management practitioners was launched. The HKMA also worked with the industry to complete the review of the Code of Banking Practice and continued to promote the smart and responsible use of banking services through the Consumer Education Programme.

REVIEW OF 2014

Overview

With the monetary policies of the major advanced economies diverging, a slowdown in growth in Mainland China and rising property prices in the local market, the HKMA continued to monitor closely AIs' credit growth and Mainland-related business. This focused on banks' management of credit and liquidity risks and stress testing to ensure the resilience of the banking sector against any abrupt changes in the macroeconomic and market environment.

Operational supervision

In early 2014, the Banking Supervision Department was restructured to better align supervisory resources with the perceived key risks facing the banking industry over the next few years. Under the new structure, three divisions are responsible for the day-to-day supervision of individual AIs and topical subjects, such as consumer credit risk, supervisory stress testing and treasury market activities. Three specialist divisions supervise AIs' corporate sector credit risk, operational and technology risks, and money laundering and financial crime risk. The HKMA considers these three areas to be the most significant risks for the banking industry in the near term warranting dedicated supervisory resources.

During the year, the HKMA continued to further enhance its supervisory approach to enable more efficient use of supervisory resources. In particular, regular on-site examinations were replaced by thematic reviews and thematic on-site examinations. Thematic reviews are in-depth off-site reviews focusing on particular risk areas or specific activities of groups of selected AIs. Based on results of the thematic reviews, the HKMA prioritised its on-site examinations of AIs.

The HKMA performed a total of 216 on-site examinations. More in-depth thematic on-site examinations on Mainland-related lending activities were conducted given their increased significance to and potential risk implications on the Hong Kong banking sector. The HKMA increased the number of examinations on treasury related

activities as well as the operational and technology risks of AIs. On-site examinations were also conducted on credit controls, stress testing and liquidity risk management, capital planning, re-developed internal ratings-based (IRB) models, and anti-money laundering and counter-terrorist financing (AML/CFT) controls of AIs. 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.

Furthermore, a total of 127 thematic reviews under the enhanced supervisory approach mentioned above were conducted covering similar areas as the thematic on-site examinations. Table 1 contains details of the operational supervision work.

In 2014, 197 off-site reviews were conducted to assess AIs' corporate governance, financial position and business operations. Supervisory attention focused on risk governance, credit growth, capital planning and readiness to implement the Basel III liquidity framework. The supervisory teams maintained frequent contact with the boards of directors and external auditors of selected AIs. 22 tripartite meetings were held with the senior management and external auditors of AIs, while 15 meetings were held with the full board or board-level committees of selected AIs.

The Banking Supervision Review Committee considered five cases, two concerning authorization of AIs, one relating to the approval of a money broker, one regarding upgrading the licence of an AI and one relating to a conduct issue.

To better utilise its supervisory resources to deal with competing priorities, the HKMA continued to invoke 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 six reports under this provision in 2014. Two of the reports covered AML/CFT controls and the remaining four were related to areas including governance and compliance framework, accounting issues, trading activities and wealth management business.

Banking Stability

No AIs breached the requirements of the Banking Ordinance relating to capital adequacy or liquidity ratio in 2014. There were 63 breaches under various sections of the Ordinance, but none affected the interests of depositors and they were rectified promptly by the AIs.

Table 1 Operational supervision

| | 2014 | 2013 |
|--|------------|------|
| 1 On-site examinations | 216 | 282 |
| Reviews of the internal ratings-based approach (IRB approach) and internal models approach (IMM approach) | 3 | 12 |
| Capital planning | 3 | 4 |
| Market risk, counterparty credit risk and treasury activities | 12 | 2 |
| Stress testing and liquidity risk management | 13 | 41 |
| Securities, investment products, insurance and Mandatory Provident Fund-related businesses | 20 | 24 |
| Deposit Protection Scheme-related representation | 13 | 12 |
| Code of Banking Practice/Consumer Protection | 1 | 3 |
| Positive mortgage data sharing | 2 | 2 |
| Anti-money laundering/counter-terrorist financing controls | 19 | 19 |
| IT, Internet banking and operational risk | 45 | 40 |
| Mainland-related business and Renminbi business | 61 | 34 |
| Credit controls, credit risk management and asset quality | 16 | 33 |
| Overseas examinations | 8 | 9 |
| Local regular examinations | - | 47 |
| 2 Thematic reviews | 127 | - |
| Reviews of the IRB approach and stress testing | 12 | - |
| Treasury activities | 36 | - |
| Anti-money laundering/counter-terrorist financing controls | 15 | - |
| IT, Internet banking and operational risk | 29 | - |
| Credit controls | 35 | - |
| 3 Off-site reviews and prudential interviews | 197 | 193 |
| 4 Tripartite meetings | 22 | 9 |
| 5 Meetings with board of directors or board-level committees of AIs | 15 | 15 |
| 6 Approval of applications to become controllers, directors, chief executives or alternate chief executives of AIs | 299 | 225 |
| 7 Reports commissioned under section 59(2) of the Banking Ordinance | 6 | 7 |
| 8 Cases considered by the Banking Supervision Review Committee | 5 | 7 |
| 9 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 ratings¹ 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 operational and technology risks

To facilitate more effective risk supervision, the HKMA centralised and strengthened its resources for supervising operational and technology risks under a single division of the Banking Supervision Department.

New or updated guidance on operational and technology risk management was issued by the HKMA, including a circular and the inaugural issue of "Operational Incidents Watch" to highlight key lessons or prudent control practices arising from significant fraud cases or operational incidents; a circular to remind AIs of the importance of ensuring the availability of critical services and effective incident management; and a circular setting out the enhanced controls required for protecting customer data and dealing with customer data leakage. In addition, the HKMA continued working with the e-Banking Security Committee of the Hong Kong Association of Banks (HKAB) on updating the Supervisory Policy Manual (SPM) module in relation to the risk management of e-banking.

¹ Comprising the Capital adequacy, Asset quality, Management, Earnings and Liquidity components.

The HKMA also collaborated with the HKAB to develop industry guidelines on the control standards for AIs' Bring-Your-Own-Device² initiatives and security controls to protect automatic teller machines (ATMs) against emerging threats.

The HKMA adopted a forward-looking and risk-focused approach to conducting on-site examinations to evaluate AIs' operational or technology risk management at the enterprise level or specific business lines. These included AIs' treasury market and derivatives activities, processing of third-party fund transfer instructions received through email or fax, operational risk management frameworks, capturing and analysis of operational risk events, business continuity management and selected technology risk management controls. In addition, the HKMA has started examining the cyber security controls of individual AIs given the growing cyber threats worldwide.

A series of off-site surveillance or supervisory activities was carried out to assess the profile and trend of AIs' operational or technology risks and risk management controls. These covered the annual self-assessment of operational risk management and independent compliance assessment for internet banking, technology risk management and business continuity planning, and the associated follow-up actions taken in relation to selected AIs. Desktop reviews were conducted to assess selected AIs' controls that were not covered by on-site examinations. Surveys were conducted to monitor AIs' status in implementing specific operational or technology controls, including the chip-based ATM technology. As regards significant operational incidents that occurred during the year, the HKMA also monitored whether AIs had implemented appropriate measures to prevent such events from recurring. In light of an increased risk of widespread disruptions to AIs' key business operations in main business districts, the HKMA organised drills involving over 50 AIs to test their ability to deal with such scenarios.

Supervision of wealth management 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' sale of securities, investment products, insurance products and Mandatory Provident Fund (MPF) schemes. Regular contact was maintained with the other regulators through bilateral and multilateral meetings, as well as under the auspices of the Council of Financial Regulators.

The HKMA also worked with the private wealth management industry and relevant training institutes to develop the enhanced competency framework (ECF) for industry practitioners, taking into account comments received during consultation with the industry in 2013. The ECF, which covers enhanced core competence and continuous professional development for private wealth management practitioners, was launched in June. The HKMA issued a circular to encourage private banks to adopt the ECF and has been monitoring implementation of the framework. Guidance was also provided to the industry and training institutes in the development and quality assurance of study materials, training programmes and examinations under the ECF.

A new half-yearly survey on the sale of investment products to private banking customers by registered institutions (RIs) commenced last year. The survey facilitates the HKMA's off-site surveillance of such activities and assists in prioritising supervisory resources to focus on any emerging issues.

The HKMA processed two applications from RIs to engage in additional regulated activities. It granted consent to 167 Executive Officers responsible for supervising the securities activities of RIs, and conducted background checks on 9,368 individuals whose information was submitted by RIs for inclusion in the register maintained by the HKMA.

² Bring-Your-Own-Device refers to the use of computing devices (e.g. personal computers, tablets and smart phones) personally-owned by staff members for work.

Banking Stability

In 2013 and 2014, the HKMA engaged a service provider to undertake a mystery shopping programme to assess AIs' sales practices in respect of investment and insurance products. A report on the results of the programme was published in December, and AIs were required to study the findings and encouraged to adopt the good practices set out in the report.

During the year, 20 on-site examinations were conducted on retail and private banks covering the selling of investment products, handling the settlement of securities transactions and safe custody of client securities, and the selling of non-linked long term insurance (NLTI) products and MPF-related products. The HKMA also continued to carry out on-site examinations and off-site surveillance to assess AIs' compliance with the performance requirements under the MPF intermediaries' regulatory regime.

The HKMA issued a comprehensive framework in March to set out the regulatory standard for the calculation of asset concentration in foreign exchange accumulators. In July, a circular was issued to highlight the findings and good practices in relation to the sale of investment products identified in the HKMA's ongoing supervision, and to remind AIs to comply with the regulatory requirements and expected standards.

The HKMA's supervisory work also identified various areas for improvement in AIs' selling practices in relation to NLTI products. To ensure appropriate protection for bank customers, and after consultation with the OCI and the banking industry, the HKMA issued guidance in December on the expected practices AIs should adopt when selling NLTI products.

In accordance with the standardised calculation methodology and disclosure format regarding intermediaries' remuneration for the sale of investment-linked assurance scheme (ILAS) products, which was issued by the OCI after consultation with the HKMA, the Hong Kong Federation of Insurers revised the remuneration disclosure statement. The revision, contained in the Important Facts Statement (IFS) and announced by the Federation in December, made it applicable to all distribution channels including AIs no later than 1 January 2015. In the same month, the HKMA issued a circular informing AIs they would need to adopt the revised remuneration disclosure statement in making pre-sale disclosure of remuneration in the sale of ILAS products, and to provide guidance to AIs on the standards expected for pre-sale remuneration disclosure and implementing the IFS requirements. At the same time, the remuneration disclosure requirement for ILAS prescribed by the HKMA in 2013 was superseded.

The Insurance Companies (Amendment) Bill 2014, which seeks to establish an independent Insurance Authority and a statutory licensing regime for insurance intermediaries, was introduced into the Legislative Council in April. The HKMA has been working with the Financial Services and the Treasury Bureau (FSTB) in the legislative process on AIs' insurance intermediary activities.

Supervision of treasury activities

The HKMA continued to devote resources to assessing AIs' control over market risk, counterparty credit risk and liquidity risk arising from their treasury and derivatives activities. In 2014, the HKMA conducted three on-site examinations on AIs' control frameworks for managing market and counterparty credit risk and 15 thematic on-site examinations on selected AIs' compliance with the standards and guidance set out in the SPM module on "Sound Systems and Controls for Liquidity Risk Management". In addition, following the issuance of the SPM module on "Code of Conduct for Benchmark Submitters" in August 2013, the HKMA conducted 23 thematic reviews on AIs' HIBOR submission systems and controls during 2014.

Supervisor-driven stress testing programme

The HKMA continued to conduct the bottom-up supervisor-driven stress testing programme 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 times of stress. A number of enhancements were introduced during the year to make the scope of the stress test more comprehensive. The HKMA has analysed the results submitted by the participating AIs and discussed with them how their processes could be further improved.

Credit risk management and asset quality

Credit growth and asset quality

The banking sector's total lending increased by 12.7% during 2014, compared with 16% in 2013 (Table 2). As loan growth outpaced the increase in customer deposits, the overall loan-to-deposit ratio increased to 72.2% at the end of 2014 from 70.3% a year ago. The asset quality of the banking sector remained sound with the classified loan ratio standing at 0.51% at the end of the year.

| % change | 2014 | 2013 |
|-----------------------------|-------------|------|
| Total loans and advances | 12.7 | 16.0 |
| Of which: | | |
| – for use in Hong Kong | 13.9 | 10.6 |
| – trade finance | -1.4 | 43.8 |
| – for use outside Hong Kong | 14.2 | 21.5 |

The HKMA remained vigilant in ensuring that AIs' credit risk is prudently managed to support their loan growth.

To promote prudent credit underwriting standards, the HKMA assessed, through thematic on-site examinations and thematic reviews, the adequacy and effectiveness of AIs' credit risk management systems. Where weaknesses were identified, the HKMA required the AIs to take appropriate remedial action within a reasonable time. For

more significant issues identified, the AIs were required to commission an independent party to conduct a more in-depth review and take appropriate action to rectify weaknesses as soon as practicable. In particular, the HKMA issued a circular reminding AIs to adopt prudent practices for the management of guarantees as credit risk mitigates.

Stable Funding Requirement

The Stable Funding Requirement (SFR) was implemented in January 2014 to ensure AIs could maintain stable business operations in the event market liquidity came under stress. Taking into consideration industry feedback and implementation experience of the SFR, the HKMA conducted a review in October with the aim of streamlining its operations and alleviating AIs' reporting burden. A circular was issued in November to formalise the implementation of the refined SFR effective from 1 January 2015.

Prudential supervision of mortgage loans

The HKMA remained vigilant towards AIs' property mortgage business, which make up a significant portion of their lending portfolios. In view of the increased risk of a property price bubble in recent years, the HKMA introduced six rounds of countercyclical prudential measures between October 2009 and February 2013 to enhance AIs' resilience to the risk of a severe adjustment in property prices. These measures included requiring AIs to tighten the maximum loan-to-value ratios for riskier property mortgages; apply more prudent criteria in assessing the repayment ability of mortgage loan applicants; limit the maximum loan tenor for all new property and stand-alone car park space mortgage loans; and share positive mortgage data. In addition, the HKMA required AIs adopting the IRB Approach to introduce a 15% risk weight floor for all new residential mortgage loans. The HKMA will continue to closely monitor the property and mortgage lending markets and will adjust the relevant measures as and when necessary in response to developments in the property market cycle.

Banking Stability

Prudential supervision of personal loans

In the light of rising household indebtedness since the global financial crisis and intense competition among banks in personal lending business, the HKMA issued a circular in January 2014 requiring AIs to adopt more prudent underwriting standards on personal loans. This included setting binding debt servicing ratio (DSR) limits, refraining from offering personal loans with long tenors, establishing portfolio-based limit structures and conducting internal stress testing.

A survey conducted by the HKMA in May on 23 AIs active in personal lending found there were variations in their relevant risk management policies and practices. This was followed up in July when a briefing session was held for the senior management of the surveyed AIs. Among other requirements, the HKMA's expectations derived from the observed market norms, such as a maximum DSR of 70% and a maximum loan tenor of 60 months, were raised as references for limits on personal loans. The AIs are required to follow these expectations and the HKMA will assess their enhanced risk management controls as part of its ongoing supervision.

US tapering and monetary policy normalisation

The US Federal Reserve ended its asset purchase programme in October following improvements in the labour market and persistent low inflation in the US. As the US economy continues to gather momentum, the market widely expects that the US policy rate will increase in 2015, signalling the beginning of monetary policy normalisation.

The prospect of higher interest rates in the US, coupled with the recent strengthening of the US dollar, may have significant implications on fund flows to Hong Kong. Although a strong recovery in the US economy may have positive implications on the Hong Kong economy, a sudden or significant reversal of fund flows may lead to volatility in asset prices and potentially jeopardise Hong Kong's financial stability. The HKMA has been closely monitoring developments and taken steps to contain the potential adverse impact of monetary policy normalisation in the advanced economies. AIs are required to be prudent in managing their liquidity and interest rate risks to cater for possible fund outflows, and the HKMA has incorporated such a scenario in its supervisory liquidity stress testing.

Mainland-related business

Mainland-related lending

The role of Hong Kong as a regional hub for financial intermediation has become more prominent in recent years as a result of Hong Kong's increasing financial and economic co-operation with Mainland China. This has contributed to the increase in the local banking sector's Mainland-related lending.

In 2014, the banking sector's total Mainland-related lending increased by 19.1%, to HK\$3,117 billion at the end of 2014 (Table 3). This included HK\$550 billion of loans booked at the Mainland subsidiaries of Hong Kong-based banks.

Table 3 Mainland-related lending

| HK\$ billion | 2014 | 2013 |
|--|--------------|-------|
| Total Mainland-related lending | 3,117 | 2,616 |
| Of which: | | |
| – Mainland-related lending excluding trade finance | 2,775 | 2,301 |
| – trade finance | 341 | 315 |

Note: Figures may not add up to total due to rounding.

As a result of the continuing rise in Mainland-related lending by AIs, the HKMA has stepped up surveillance and introduced regular surveys requiring AIs active in such lending to report more frequent and detailed information to the HKMA for analysis.

Prevention of money laundering and terrorist financing

The Anti-Money Laundering and Financial Crime Risk Division was established in March to strengthen and consolidate the resources for AML/CFT supervision. By adopting a forward-looking and proportionate approach, the HKMA's supervision focuses on identifying significant and emerging risks, and ensuring that AIs' AML/CFT controls are effective in addressing these risks. 21 on-site examinations (including 2 overseas examinations) and 15 desk-based reviews were conducted in 2014, a number of which were thematic, picking up on important AML/CFT areas such as controls over financial sanctions.

To ensure money laundering and terrorist financing risks are properly assessed by each AI and that the results of the HKMA's assessments are used effectively in the design of AIs' AML/CFT systems, the HKMA performed desk-based reviews supplemented by training and guidance to the banking industry. Increased attention has also been given to AI's AML/CFT compliance culture and how money laundering and terrorist financing risks are managed by AIs' senior management.

Internationally, the HKMA maintains engagement with the global AML/CFT community to ensure that its supervisory approach is consistent with the international standards and other financial centres. The HKMA participated in one of the first Financial Action Task Force Assessments under the new standards during 2014 and is also an active participant in the AML/CFT Expert Group established by the Basel Committee.

Risk governance

The HKMA stepped up efforts to instil a strong risk culture within AIs, particularly in terms of engagement with the boards of directors of local retail banks or their board-level committees on management oversight of internal controls and accountability for risk management. Feedback and comments on the performance of board members or board committee members were provided generally or on specific supervisory matters. A survey on the roles and authority of chief risk officers of local retail banks was conducted to ascertain the prevailing risk governance structure. A preliminary review of the risk appetite statements of local retail banks was carried out to take stock of the current standards and to suggest improvements with reference to relevant guidance issued by the Financial Stability Board (FSB).

Co-operation with overseas supervisors

The HKMA participated in college-of-supervisors meetings organised by the home supervisors of 20 banking groups with significant operations in Hong Kong. Issues of common interest were discussed, including key areas of supervisory focus, financial performance, stress testing, credit, operations, anti-money laundering and other types of risk management and supervisory issues relating to these banking groups.

Bilateral meetings were held during the year with banking supervisors from Australia, France, Germany, India, Japan, the Mainland, Malaysia, the Netherlands, the Philippines, Singapore, Switzerland, Taiwan, the UK and the US to ensure effective co-operation and co-ordination. There were also regular exchanges with overseas authorities on institution-specific issues and developments in financial markets.

The HKMA participated in the crisis management groups (CMGs) of 10 banking groups organised by the relevant home authorities to discuss resolution strategy and oversee production of the recovery and resolution plans of each banking group in accordance with the principles established by the FSB. The HKMA also participated in the pilot resolvability assessments for four of these groups. As an FSB member, the HKMA contributed its views on proposals for the loss-absorbing capacity of the global systemically important banks in resolution, the cross-border resolution framework, and funding for firms in resolution in the Cross-Border Crisis Management working group. The HKMA organised a regional CMG for the host regulators from the Asia-Pacific region about a local banking subsidiary of one UK-based international bank with extensive operations in the region.

Banking Stability

Basel III

Implementation of Basel III in Hong Kong

The HKMA implemented the second phase of the Basel Committee on Banking Supervision's Basel III capital standards with the Banking (Capital) (Amendment) Rules 2014 (BCAR 2014), which came into effect on 1 January 2015 in accordance with the Basel Committee's transition timetable.

Capital standards

Pillar 1

The second phase of Basel III implementation introduced capital buffer requirements for AIs, namely a capital conservation buffer (CB), a countercyclical capital buffer (CCyB) and, for those AIs designated as systemically important, a higher loss absorbency (HLA) requirement. These buffer requirements are designed to provide incentives to AIs to build up and hold, outside periods of stress, an additional layer of Common Equity Tier 1 (CET1) capital over and above the "hard" minimum CET1 capital ratio. Each of the three buffer requirements is expressed as a ratio of an AI's CET1 capital to its total risk-weighted assets. AIs may operate within the "buffer zone" but will be subject to restrictions on their ability to make discretionary distributions while their CET1 capital levels are within the "zone". In order to avoid distribution constraints, an AI will need to maintain —

- (a) a CB of 2.5%;
- (b) a CCyB ranging from 0% to 2.5%, which is specific to each AI as it is determined as the weighted average of the CCyBs set by the relevant authorities of the jurisdictions in which that AI has private sector credit exposures; and

- (c) if the AI is designated by the HKMA as systemically important either globally, as a global systemically important bank (G-SIB), or domestically as a domestic systemically important bank (D-SIB), an HLA requirement ranging from 1% to 3.5%, depending on the AI's perceived level of systemic importance.

In line with the Basel Committee timetable, the CB, CCyB and HLA requirements will be phased in, through equal annual increments, from 2016 to 2019. However, in the case of the CCyB, the HKMA may, under certain conditions specified in the Banking (Capital) Rules (BCR), accelerate the phase-in of the Hong Kong CCyB rate and/or set it at a level above 2.5%.

Pillar 2

The HKMA anticipated the 2016 implementation of the Basel III capital buffers when making changes in 2013 to its "Supervisory Review Process" (SRP, the local Pillar 2 framework) to accommodate the Basel III framework generally. The changes made to the SRP were designed to address any potential overlap between the existing Pillar 2 capital requirements and the capital buffers when the latter come into effect. Therefore, no further changes were required to the SRP in 2014. The basic concept underpinning the HKMA's SRP remains that Pillar 2 capital is, and will continue to be, a constituent part of an AI's minimum regulatory capital requirements.

Basel III (continued)

Pillar 3

The implementation of the second phase of Basel III also introduces new disclosure requirements for AIs from 2015 in connection with their capital buffers, the Liquidity Coverage Ratio, and the Leverage Ratio. To this end, the Banking (Disclosure) Rules (BDR) were amended by a set of Banking (Disclosure) (Amendment) Rules 2014 (BDAR 2014), which were published in the Gazette on 24 December 2014, and came into operation on 31 March 2015.

Liquidity standards

In addition to strengthening regulatory capital requirements, Basel III introduces the first global liquidity standards, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), to improve banks' resilience to liquidity stress. The standards are accompanied by a complementary set of liquidity monitoring tools for supervisors' surveillance of banks' liquidity risk exposure to further strengthen and promote consistency in liquidity risk supervision globally.

To implement the Basel III liquidity standards, the HKMA issued a set of Banking (Liquidity) Rules (BLR) in October 2014 which came into operation from 1 January 2015.

Under the BLR, the LCR applies to those AIs designated by the HKMA as "category 1 institutions". These are principally internationally active AIs or those larger or more sophisticated AIs that are significant to the general stability of the local banking system. Other AIs not designated as category 1 institutions (category 2 institutions) are subject to a Liquidity Maintenance Ratio (LMR), which is a modified version of the Liquidity Ratio applicable to all AIs prior to 2015.

To facilitate the smooth implementation of the new liquidity regime, a Code of Practice was issued in December 2014 to provide technical guidance on the calculation of total net cash outflows which is the denominator of the LCR. A set of standard calculation templates, which form the basis of the regulatory Return of Liquidity Position of an AI, have also been developed to facilitate AIs' calculation and reporting of the LCR and the LMR where applicable. The Code of Practice and the templates commenced operation, together with the BLR, from 1 January 2015.

A modified version of the NSFR was published by the Basel Committee in October 2014, following public consultation. Major modifications to the NSFR included the recalibration of various classes of available stable funding (ASF) and required stable funding (RSF) items to –

- (i) better address potential funding risks relating to certain types of transaction (principally derivative transactions) and funding models (such as secured or unsecured short-term wholesale funding models);
- (ii) enhance coherence with the concepts underlying the LCR (including preferential treatment for funding transactions conducted with central banks or collateralised by high quality liquid assets (HQLA)); and
- (iii) introduce a more granular term structure, by dividing the original 12-month time horizon into two 6-month periods, to better reflect the liquidity risk attributes of ASF and RSF items maturing in different periods.

Banking Stability

Basel III (continued)

The Basel Committee's intention is that the revised NSFR standard should be implemented from 1 January 2018. The HKMA will review the revised requirements in 2015 and consider the most appropriate approach for implementing the standard in Hong Kong.

Leverage ratio

Basel III introduces a simple non-risk-based leverage ratio as a complementary measure to the risk-based capital requirements to limit the potential for excessive leverage within banks. Under the Basel Committee's implementation timetable, the leverage ratio is initially subject to a parallel run from 2013 to 2017 when banks are required to report their leverage ratios to their supervisory authorities for regulatory monitoring, before the leverage ratio becomes a binding requirement from 2018. Disclosure of banks' leverage ratios is scheduled to begin in 2015. All Hong Kong-incorporated AIs have been required to report their leverage ratio positions quarterly to the HKMA for the purposes of the parallel run, and amendments were made to the BDR, through the BDAR 2014, to introduce the public disclosure requirements.

SIFI framework

Following initial industry consultation, the HKMA issued a draft SPM module on "Systemically Important Banks" in October 2014. The draft module, which complements the BCR, sets out the HKMA's assessment methodology for identifying AIs in Hong Kong to be designated as D-SIBs or G-SIBs and for calibrating the level of any additional HLA capital requirements to which they will be subject. The module also discusses other policy and supervisory measures to be applied to local D-SIBs and G-SIBs to address the risks they pose.

Supplementary guidance for Basel III implementation

An updated SPM module providing an "Overview of Capital Adequacy Regime for Locally Incorporated Authorized Institutions" and reflecting the current regulatory capital framework in Hong Kong under Basel III, was issued for industry consultation in September 2014. The module was gazetted in February 2015.

The HKMA also issued in December an updated set of FAQs to clarify the application of various provisions in the BCR and the BDR.

To explain its proposed approach to implementing the CCyB and to setting appropriate CCyB rates in Hong Kong, the HKMA issued in January 2015 a SPM module on "Countercyclical Capital Buffer (CCyB) – Approach to its Implementation". As an AI's specific CCyB requirement is determined by the geographic mix of its private sector credit exposures and the CCyB rates applicable in the jurisdictions in which it operates, the HKMA, in November 2014, set out guidance in another separate SPM module on "Countercyclical Capital Buffer (CCyB) – Geographic Allocation of Private Sector Credit Exposures", to explain how an AI's private sector credit exposures should be allocated geographically for CCyB purposes.

Basel III (continued)

Basel III implementation monitoring process

Since 2011, the HKMA has been contributing data from selected locally-incorporated AIs for the Basel Committee's quantitative impact study (QIS) to facilitate assessment of the impact of the Basel III capital³ and liquidity requirements and the monitoring of banks' progress in their implementation.

The HKMA also carried out a similar QIS locally on liquidity, covering a broader sample of AIs. The information collected in the QIS has enabled the HKMA to better assess the effects of the liquidity standards on different types of AI (such as those that are incorporated outside Hong Kong, wholesale-oriented in their business, or predominantly retail-based) and has been helpful for the HKMA's policy decisions on implementing the liquidity standards in Hong Kong.

Basel Committee Regulatory Consistency Assessment Programme

The Basel Committee established its Regulatory Consistency Assessment Programme (RCAP) in 2012 to monitor, assess and evaluate its members' implementation of the Basel standards. A key objective of the RCAP is to assess the consistency of the implementation of a jurisdiction's capital and liquidity requirements in relation to the minimum standards set out in the Basel II, Basel 2.5 and Basel III standards. By promoting full, timely and consistent implementation of the Basel standards, RCAP helps strengthen the international banking system, improve market confidence in regulatory ratios, and ensure

a level playing field. Ultimately, all Basel Committee member jurisdictions will be expected to undertake at least one round of RCAP assessment by 2016. The RCAP assessment of Hong Kong (covering both capital and liquidity standards) was conducted by the Basel Committee in 2014. The RCAP reports for Hong Kong were published in March 2015. Overall, Hong Kong's capital and liquidity regulations were assessed as "compliant" with the Basel standards.

In addition to being assessed under the RCAP, the HKMA participated in RCAP assessments of other jurisdictions during the year. The HKMA joined technical experts from Australia, Japan, Mexico, Switzerland and the US to complete an assessment of the European Union, the report of which was published in December 2014. The HKMA, as a leader of an international team, was also in the process of conducting an RCAP assessment of India.

³ In the case of capital requirements, the impact is assessed on a fully implemented basis, including capital buffers and HLA requirements for systemically important financial institutions.

Improving Supervisory Policy Framework

Regulation of over-the-counter (OTC) derivatives transactions

In April, LegCo enacted the Securities and Futures (Amendment) Ordinance 2014 (Amendment Ordinance), which provides a regulatory framework for the OTC derivatives market in Hong Kong to meet relevant G20 commitments. The framework will be overseen by SFC for licensed corporations and central counterparties, and the HKMA for AIs and approved money brokers (AMBs). It provides for the imposition of mandatory obligations on the reporting, clearing and trading of specified OTC derivatives transactions, and introduces complementary record keeping requirements.

The HKMA will develop supervisory guidelines to support the phased implementation of the new framework for AIs and AMBs. As the first phase of implementation, covering mandatory reporting and related record keeping obligations, is expected to take effect within the first half of 2015, the HKMA intends to issue the corresponding supervisory guideline for industry consultation when the rules for reporting and related record keeping obligations are finalised.

Monitoring tools for intraday liquidity management

In March, the HKMA issued for industry consultation its proposals and draft reporting templates for local implementation of the Basel Committee guidance, *Monitoring Tools for Intraday Liquidity Management* (April 2013). The HKMA expects to finalise the reporting templates (taking into account industry comments) in the course of 2015. In light of the implementation approaches adopted by other supervisors and the time and resources required for AIs to adapt their reporting systems and data, there will be a grace period before reporting of intraday liquidity positions commences.

Other policy development work

Financial Sector Assessment Program (FSAP)

The FSAP team (led by the International Monetary Fund) conducted an assessment of the local financial sector in 2013 to assess the financial stability of Hong Kong. The report was published in July 2014⁴. Overall, the results were positive, with Hong Kong maintaining a very high level of compliance with the Basel Core Principles for Effective Banking Supervision. Of the 29 Core Principles, 26 were assessed as "compliant" while the remaining three were assessed as "largely compliant". Stress test results also suggested that AIs were well positioned to absorb any significant materialisation of risk.

⁴ See Basel Core Principles for Effective Banking Supervision — Detailed Assessment of Observance, issued by the IMF, July 2014: <http://www.imf.org/external/pubs/ft/scr/2014/cr14207.pdf>

Accounting standards

Work on the convergence of accounting standards by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) is nearing completion. However, on loan loss provisioning, while the two boards have developed respective new standards on the basis of expected credit losses, they are not fully converged in the treatment of performing loans and hence two different expected loss models will be implemented. The FSB will hold a round table in early 2015 for standard setters, supervisors and regulators, and other stakeholders to discuss how to promote further consistency of implementation of the two boards' accounting standards for financial instruments. Domestically, the HKMA has had initial discussions with bank auditors on AIs' plans for implementation of the new standard *IFRS 9 Financial Instruments* and the likely impact of the standard on AIs in general.

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 on the banking industry, and key domestic and international supervisory policy initiatives, including those related to banks' external auditors.

Recovery and resolution

As part of its package of policy measures to reduce the risks posed by systemically important financial institutions, the FSB issued the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes) in November 2011. In late 2014, the FSB reissued the Key Attributes with new annexes providing guidance on implementation in relation to information sharing for resolution purposes and on certain financial institutions operating in the non-bank sector as well as issuing a consultation on the recognition of cross-border resolution actions. All FSB member jurisdictions are expected to meet these international standards, in line with any supporting guidance, to ensure that both public

authorities and financial institutions will be better placed to respond effectively to shocks that threaten the financial soundness of individual financial institutions, including financial market infrastructures, which could undermine the provision of critical financial services and the general stability and effective operation of the financial system.

The Hong Kong authorities have conducted an assessment of the extent to which existing intervention powers and arrangements meet the standards in the Key Attributes. It was identified that while a relatively well-developed statutory and regulatory framework is already in place, some significant gaps still exist. This assessment was confirmed by the FSB in a thematic peer review in 2013 as well as by the IMF which concluded that there was a strong case for reform after undertaking its own assessment of Hong Kong's crisis management arrangements as part of the FSAP in 2014. The HKMA, working with the FSTB, the SFC and the Insurance Authority (IA), contributed to a public consultation, issued by the FSTB in January 2014, on proposals for legislative reform to provide for a cross-sectoral resolution regime to address identified gaps in the existing framework against the standards set out in the Key Attributes. During the three-month consultation period, 33 formal responses were received, indicating broad support for the implementation of a resolution regime in Hong Kong meeting international standards. Following this first consultation, the authorities have developed their proposals and issued a second public consultation in January 2015 with further details on the bail-in resolution option; the governance arrangements and in particular the approach to designating resolution authorities; as well as safeguards including a 'no creditor worse off than in liquidation' compensation mechanism.

The Key Attributes also require jurisdictions to implement local recovery and resolution planning requirements covering, at a minimum, domestically incorporated financial institutions that could pose a threat to financial stability if they were to fail. Following consultations with the industry, the HKMA, in June 2014, issued an SPM module on "Recovery Planning" for AIs. The first wave of larger, more complex AIs submitted their first Recovery Plans in December 2014.

Banking Stability

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 a member of a number of sub-groups under the Policy Development Group, including the Working Group on Capital, the Working Group on Liquidity, the Working Group on Disclosure, the Large Exposures Group, the QIS Working Group, the Task Force on Standardised Approaches, and the Task Force on Interest Rate Risk in the Banking Book. The HKMA is also a member of some sub-groups under the Supervision and Implementation Group, including the Working Group on SIB Supervision, the Colleges Working Group, the Task Force on Banking Book, and the Task Force on Impact and Accountability, and participates in the Basel Committee and International Organization of Securities Commissions' (IOSCO) Joint Working Group on Margining Requirements.

The HKMA is a member of the FSB Plenary Meeting, FSB Standing Committee on Supervisory and Regulatory Co-operation, and FSB Standing Committee 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 Supervisory Intensity and Effectiveness Group, the Compensation Monitoring Contact Group, and the Workstream on Other Shadow Banking Entities.

At the regional level, 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 (SEANZA). 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 being discussed at the Working Group's meetings.

International Conference of Banking Supervisors

The HKMA continues to actively participate in supervisory forums internationally. In September, the HKMA took part in the 18th International Conference of Banking Supervisors (ICBS) held in Tianjin, which was attended by 120 banking supervisors from over 90 jurisdictions and representatives from international financial institutions. The meeting was jointly organised by the China Banking Regulatory Commission (CBRC) and the Basel Committee. The ICBS' goal is to deepen the supervisory dialogue and co-operation on measures to strengthen the long-term resilience of the global financial system. The conference discussed a range of supervisory policies and measures relating to post-crisis reforms as well as the role of the banking system and financial services in supporting the real economy and promoting economic growth.

FSB Peer review of Germany

In the context of the FSB's peer review programme in 2013/2014, the HKMA led an international expert team which conducted a peer review of Germany. The team's final report was approved by the FSB and was published in April 2014. The expert team 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 in Germany, that were deemed most important and relevant to the FSB's core mandate of promoting financial stability.

Bank consumer protection

Code of Banking Practice

The industry's overall compliance with the Code of Banking Practice remained satisfactory. In the industry's annual self-assessment, covering the period from 1 January to 31 December 2013, all AIs reported full, or almost full, compliance⁵. The non-compliance issues reported mostly involved transparency and disclosure of information and the related policies and procedures. The

⁵ With five or fewer instances of non-compliance.

Als concerned have taken steps to address the issues. The HKMA also conducted a thematic examination of one AI to review its compliance with the Code and related policies and controls.

The Code of Banking Practice Committee, on which the HKMA is represented, completed a comprehensive review of the Code in 2014. The revised Code will provide a wider protection to customers, promote good banking practices as well as enhance the provisions of the Code to align with international standards on financial consumer protection. Major enhancements to the Code, covering a wide range of banking products and services, include:

- extending the coverage of the Code to subsidiaries and affiliated companies controlled by Als which are not licensed, regulated or supervised by other financial regulators;
- incorporating the *G20 High-level Principles on Financial Consumer Protection* as general principles in the Code;
- enhancing the disclosure and transparency about terms and conditions by Als, which include the provision of new standardised Key Facts Statements by Als setting out major terms and conditions of loan products to allow customers to easily access and compare details of such products, as well as explaining any revisions of terms and conditions of banking services;
- enhancing credit card related practices of Als⁶; and
- providing more explanation on the customer due diligence requirements in relation to the opening of accounts, which would help members of the public to have a better understanding of the requirements and the basic types of documents which may be required of them for such purposes.

⁶ Enhancements include (i) to obtain the consent of the customers for upgrade and replacement of credit cards; (ii) to terminate non-activated cards after reminders for activation have been sent to the cardholders, hence non-activated cards will not be auto-renewed; and (iii) not to levy annual fees on non-activated cards.

The revised Code will become effective on 6 February 2015. Als are expected to achieve full compliance with the new provisions as quickly as possible within six months of the effective date. Another six-month grace period is allowed for compliance with those provisions that require system changes by the Als. The HKMA will monitor compliance as part of its ongoing supervision of Als.

G20 High-level Principles on Financial Consumer Protection

The HKMA continued to participate in the Task Force on Financial Consumer Protection of the OECD to develop effective approaches to support the implementation of the *G20 High-level Principles on Financial Consumer Protection*. Following the publication of the effective approaches for three higher-priority principles in September 2013, the effective approaches for the remaining seven principles⁷ were developed and endorsed at the G20 Summit in November 2014.

Treat Customers Fairly Charter

Following the launch of the Treat Customers Fairly Charter in October 2013, the HKMA, after consultation with the industry associations, issued a circular to all Als in March 2014, providing a list of examples to assist them in developing a customer-centric culture that ensures customers are treated fairly and customers' interests are taken into account in everyday business decisions at all levels of Als.

In support of the Charter principles, banks have exempted vulnerable customers and low-income customers from initial deposit requirements for opening accounts. This is in addition to the measures adopted in 2013 to abolish dormant account fees, waive low-balance fees for vulnerable customers and adopt a flexible approach to the charging of low-balance fees for low-income customers⁸.

⁷ The remaining seven principles are: legal, regulatory and supervisory framework; role of oversight bodies; equitable and fair treatment of consumers; financial education and awareness; protection of consumer assets against fraud and misuse; protection of consumer data and privacy; and competition.

⁸ The flexible approach includes either treating the low-income customers as vulnerable customers and waive the low-balance fee or providing them with unlimited/limited free access to branch counter services in relation to their use of basic bank accounts which do not have a minimum balance requirement.

Banking Stability

Credit data sharing

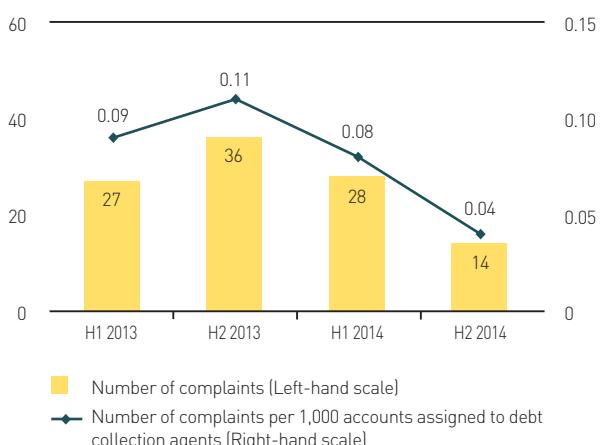
At the end of 2014, 116 AIs and subsidiaries of AIs were sharing commercial credit data through the Commercial Credit Reference Agency (CCRA). The scheme contained the credit data of more than 125,600 business enterprises, about 17% of which were sole proprietorships and partnerships. On the sharing 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 action 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 42 from 63 in 2013 (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



Bank consumer education

The HKMA continued its Consumer Education Programme to educate the public to be smart and responsible in the use of banking services. One of the major initiatives was the launch of a series of short video clips to promote responsible credit card spending and security awareness when using self-banking services such as ATMs, the internet and mobile banking. To reach a wider audience, the videos were broadcast and promoted on the internet (such as the HKMA Smart Tips Channel on YouTube), smartphone apps, public transport, out-of-home and print media, the HKMA Information Centre and the Coin Carts.



Consumer education video promoting security awareness when using mobile banking.



Publicity for the video series on different platforms.

Thematic campaigns with smart tips publicised on radio, in the print media and on the internet were also used to promote public understanding of personal loans, as well as to remind bank customers to activate their new chip-based ATM cards. In addition, light-hearted audio clips promoting smart tips on different topics were broadcast on radio and smartphone apps.



Feature article on the issues to note in using personal loans.

Roving exhibitions were organised during the year to disseminate educational messages. The exhibitions included stage performance, information panels, game booths, an audio kiosk and photo booths. Educational leaflets and souvenirs were also distributed and post-event publicity was arranged in the print media to reinforce the messages.



Disseminating educational messages to the public through roving exhibitions.

Apart from organising talks and seminars for young people, the HKMA collaborated with stakeholders including the Investor Education Centre and St. James Settlement to promote responsible spending and enhance the financial literacy of students of tertiary institutions and senior secondary schools through various campaigns.

The HKMA also provided advice to the Investor Education Centre on educational materials published during the year to improve the public's understanding of insurance as part of financial planning and some important features about insurance products.

Banking Stability

Enforcement

Banking complaints

The HKMA received 1,234 banking complaints (an increase of 10.7% compared with 2013) and completed the handling of 1,334 cases in 2014. At the end of the year, the total number of outstanding cases was reduced to 400 (Table 4).

Table 4 Banking complaints received by the HKMA

| | 2014 | | 2013 | |
|--|------------------------|--------------------------|---------|---------|
| | Conduct-related issues | General banking services | Total | Total |
| In progress on 1 January ^{Note} | 253 | 247 | 500 | 1,313 |
| Received during the year | 151 | 1,083 | 1,234 | 1,115 |
| Completed during the year | (244) | (1,090) | (1,334) | (1,928) |
| In progress on 31 December | 160 | 240 | 400 | 500 |

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

Complaints relating to provision of banking services ranked highest in 2014, increasing by 127% to 175. The increase was mainly attributable to complaints about the termination of business relationships by AIs following customer due diligence processes and commercial decisions by some AIs to cease providing services related to a particular type of foreign exchange margin trading account. The number of complaints relating to insurance products increased by 25 % to 116, while complaints relating to ILAS products decreased by 14% to 38. Complaints regarding mis-selling of investment products declined by 20% to 47 and those related to credit card fees and charges by 23% to 48. Other major types of complaints included those related to credit card transactions (increased by 41% to 55), those related to client agreements (increased by 58% to 52) and complaints about ATM services (increased by 34% to 51).

During the year, the HKMA streamlined the operational workflow of its complaints handling process. As a result, around 60% of the general banking services complaints received were handled within three months, of which more than half were completed within two months. The complainants in around 75% of cases involving general banking services were satisfied after receiving the banks' final reply.

Enforcement actions

HIBOR fixing

In March, the HKMA announced the outcome of its investigation into the Hong Kong Interbank Offered Rate (HIBOR) fixing of nine HIBOR reference banks. The HKMA found evidence of misconduct in the submission of HIBOR rates by UBS AG (UBS), but no evidence of collusion among the nine banks to rig the HIBOR fixing. The HKMA investigation also found that UBS had failed to report the misconduct of its staff to the HKMA, and there were material weaknesses in UBS's internal controls and governance in managing the HIBOR submission process and in other areas. UBS was required to take appropriate disciplinary actions against the individual staff members concerned, implement a remedial plan for the weaknesses identified, and engage an independent reviewer to assess the effectiveness of the remedial measures following implementation.

Emerging Markets Rates business

In April, the HKMA announced its findings against The Royal Bank of Scotland plc (RBS) concerning internal control failures in detecting and preventing unauthorised trading activities in its Emerging Markets Rates business in Hong Kong from May 2008 to October 2011, in conjunction with the disciplinary action taken by the SFC. As a result of the HKMA's investigation, RBS was required to implement corrective measures and take appropriate action against staff who failed to adequately perform their duties or otherwise bore responsibility for the failures identified. Pursuant to section 59(2) of the Banking Ordinance, RBS was also required to appoint an external auditor to conduct an independent review on the effectiveness of its corrective measures and report the results to the HKMA.

Foreign exchange trading operations

In December 2014, the HKMA announced the outcome of its investigation into the foreign exchange (FX) trading operations of 10 banks in Hong Kong. The HKMA investigation found no evidence of collusion among the banks investigated and no evidence of any rigging of FX benchmark fixings in Hong Kong or in other jurisdictions except for a case of suspected attempt to influence an Asian currency benchmark fixing. As regards FX trading, the investigation discovered one case involving a failed attempt by a Hong Kong-based trader to influence the USD/HKD spot rate at the request of a colleague in another Asian jurisdiction. The investigation also identified certain control deficiencies resulting in some isolated cases of communication indiscretions. Possible information that may relate to counterparties or clients was disclosed to other banks. But no evidence of market manipulation was found. The HKMA took actions against the banks and their staff concerned according to the severity of the inappropriate conduct or weaknesses found.

Others

During the year, disciplinary sanctions, ranging from suspension to life ban, were imposed by the SFC on eight former relevant individuals following referral by the HKMA. The HKMA issued 41 compliance advice letters to AIs and their staff that were found not acting in full compliance with the relevant regulatory requirements, but whose lapses did not warrant disciplinary sanctions.

Complaints Watch

As part of the HKMA's initiatives to promote proper standards of conduct and prudent business practices among AIs, a periodic newsletter *Complaints Watch* was introduced in May to share with the banking industry information on latest complaint trends and emerging topical issues. Topics covered in the 2014 newsletters included complaints relating to insurance products, merchant name displays on credit card statements, resumed debt collection after a long period of non-action, terminating services due to business strategy changes, unauthorised transactions, and remittance frauds.

Deposit Protection

The Deposit Protection Scheme (DPS) continued to offer protection to deposits up to \$500,000 per depositor per bank. The DPS was reviewed by the IMF as part of the FSAP review of the crisis management framework in Hong Kong. The review covered the functioning of the DPS in contributing to financial stability with reference to international principles. The IMF concluded in its report of May 2014 that the DPS in Hong Kong contained many good features, and that it was transparent and trusted. It recommended that Hong Kong should consider further enhancing payout efficiency and conduct a review of the funding modalities.

The IMF's recommendations were incorporated into an enhancement plan for achieving prompt payout, which was issued for public consultation in September. The main proposal is for the adoption of gross payout (as opposed to the current requirement of setting off customer liabilities against protected deposits when determining DPS compensation) and other technical enhancements. The submissions received during the consultation were supportive of the proposals.

Other initiatives undertaken in 2014 to enhance payout efficiency included an upgrade of the payout infrastructure and system, development of more sophisticated pre-payout preparatory procedures, and the identification of electronic payment channels for supporting faster payout. The sustainability of the DPS Fund was reviewed during the year and it was concluded that no change to the existing funding structure was required.

The monitoring of compliance with the requirements in relation to representation about DPS protection by member banks to the Scheme (Scheme members) was conducted through annual self-assessments by Scheme members and on-site examinations by the HKMA. The compliance of Scheme members was generally satisfactory. Good progress was made by Scheme members in preparing to meet the revised requirements on submission of deposit records issued in September 2013.

Continuous publicity and community education campaigns were undertaken to promote the DPS to the general public and targeted groups. The general awareness of the DPS remained at a high level of 78%.

Banking Stability

Oversight of financial market infrastructures

The HKMA issued a policy statement in 2013 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, limit systemic risk and foster transparency. The aim is to make the FMIs more resilient to financial crises and protect the monetary and financial systems in Hong Kong from possible destabilising effects arising from disruption to the FMIs. The policy statement, which is available on the HKMA website, is updated from time to time to reflect changes to the oversight framework.

The Clearing and Settlement Systems Ordinance (CSSO) empowers the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre. Its purpose is to promote the general safety and efficiency of the designated systems: the Central Moneymarkets Unit (CMU), the Hong Kong dollar Clearing House Automated Transfer System (HKD CHATS), the US dollar CHATS, the Euro CHATS, the Renminbi CHATS and the Continuous Linked Settlement (CLS) System. The HKMA is also responsible for overseeing the OTC Derivatives Trade Repository (HKTR), which is owned and operated by the HKMA. Since it is not a clearing or settlement system, it is not designated as such under the CSSO. 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 designated systems under its purview. All the designated systems and the HKTR are treated as FMIs in Hong Kong.

The HKMA continued to incorporate international standards into its oversight framework of FMIs. The Committee on Payments and Market Infrastructures (CPMI) 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 constitute 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. The HKMA and SFC jointly issued a policy statement in March 2013 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 2013, an amended statutory "Guideline on the Oversight Framework for Designated Systems" under the CSSO and, in July 2013, a new "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 the FMIs under its purview to ensure observance of the PFMI, including requesting them to make necessary changes in specific areas to conform to the relevant requirements, and be generally observant of the PFMI by 31 December 2015.

International participation

The HKMA is a member of the CPMI and participates in meetings, working groups and forums on FMI oversight matters. It also participates in the CPMI-IOSCO Implementation Monitoring Standing Group, which is responsible for monitoring and assessing the implementation of the PFMI by different jurisdictions. In addition to participating in the monitoring and assessment of other jurisdictions, the HKMA is also one of the parties being assessed. The Level 1 assessment, which reviewed whether jurisdictions had completed the process of adopting legislation and policies to implement the PFMI, concluded that the HKMA had adopted the PFMI within its oversight framework.

The HKMA is also a member of the Oversight Forum of the global message carrier SWIFT (the Society for Worldwide Interbank Financial Telecommunication), which discusses relevant oversight matters and shares SWIFT-related information. Hong Kong's AIs and FMIs use, and rely on SWIFT's services and may be exposed to risks in the event of any disruption to its operations.

The HKMA 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 operational and development matters as well as Hong Kong dollar-specific issues to ensure the System continued to meet the safety and efficiency requirements under the CSSO.

In addition to the CLS System, the HKMA held discussions with relevant overseas authorities to further strengthen the co-operative oversight of links between the FMs in Hong Kong and those overseas. In particular, the HKMA discussed strengthening the existing co-operative oversight arrangements for the PvP links between USD CHATS and the Malaysian ringgit, Indonesian rupiah, and Thai baht RTGS systems. The HKMA also strengthened the co-operative oversight of links between the CMU and overseas systems.

In October, the HKMA entered into a Memorandum of Understanding with the National Bank of Belgium on the "Co-operation and communication framework regarding the co-operative oversight of the Hong Kong Financial Market Infrastructure-Euroclear Bank linkages". Appropriate co-operative oversight arrangements will be established with other overseas regulators as required.

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 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 2014 and reviewed four regular reports and 23 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 2014, 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 2014, 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.

Banking Stability

Licensing and Director Development Programme

At the end of 2014, Hong Kong had 159 licensed banks, 21 restricted licence banks, 23 deposit-taking companies and 16 approved money brokers. During the year, the HKMA granted two banking licences to two foreign banks, one restricted banking licence to a local subsidiary of a foreign banking group, upgraded a foreign-incorporated restricted licence bank to a licensed bank, and approved one money broker incorporated outside Hong Kong. One restricted licence bank (the one which was upgraded to a licensed bank) and one deposit-taking company revoked their authorization during the year.

The Advisory Group on Skills and Knowledge Development for Bank Directors, led by the HKMA, held its inaugural meeting in January 2014 to advise on the topics and types of activity that should be included in the induction training and continuing development programmes for directors of locally-incorporated AIs. In this context, the HKMA worked with the Hong Kong Institute of Bankers (HKIB) during the year to develop induction and continuing development programmes for directors. In view of the positive response to the introductory-level Corporate Governance programme held in 2013, the HKIB repeated the programme to provide an opportunity for more directors to participate. The HKIB also organised a topical seminar on anti-money laundering standards and another on digital trends and cyber security. The seminars provided a useful channel for keeping directors up to date with developments in regulatory requirements and emerging risks facing the industry.

In 2014 the HKMA organised two experience-sharing sessions for recently appointed independent non-executive directors (INEDs) of locally-incorporated AIs. These were informal small group sessions aimed at providing an opportunity for participants to share their experiences and any challenges they encountered when undertaking their duties as INEDs. The sessions provide a candid insight into how INEDs approach their roles and their views on requirements for training and other support.



Deputy Chief Executive of the HKMA, Mr Arthur Yuen, speaks at the press conference on 2013 Year-End Review and Priorities for 2014 for the Hong Kong Banking Sector on 24 January 2014.

PLANS FOR 2015 AND BEYOND

Supervisory focus

Credit growth and asset quality

Because of the uncertain global economic conditions and the possible adverse impact of interest rate normalisation on asset prices and loan quality, the HKMA will continue to closely monitor the asset quality of AIs' lending portfolios, and ensure that Hong Kong's banking system is resilient to the potential downturn in the credit cycle.

Mainland-related business

Proactive steps will again be taken to promote prudent credit underwriting and risk management practices for Mainland-related lending activities. In addition to on-site examinations and off-site analyses of the effectiveness of AIs' risk management systems for Mainland-related lending business, the HKMA will closely monitor AIs' progress in enhancing their systems for identifying emerging risks and detecting early signs of deterioration in asset quality.

Prevention of money laundering and terrorist financing

The HKMA will work with the Government and the industry to step up money laundering and terrorist financing risk assessments at all levels, which will help determine changes that may be required to Hong Kong's AML/CFT legal and regulatory regime.

The strengthened programme of AML/CFT examinations will continue while a collaborative partnership with the industry will be maintained to develop further guidance in key areas.

Risk governance

The HKMA will continue to participate in various board or board-level committee meetings of local retail banks to evaluate the risk governance standards and identify room for improvement. Local retail banks have been requested to revise their risk governance frameworks and risk appetite statements in 2015 to bring them in line with the FSB standards and market practices. The HKMA will also conduct interviews with the chief risk officers of local retail banks to cultivate a stronger sense of risk governance, and a more structured approach will be developed to raise the risk governance of AIs.

Supervision of treasury activities and liquidity risk

The HKMA will continue to conduct on-site examinations of AIs' treasury and derivative activities. Given the implementation of the new liquidity regime in Hong Kong, the HKMA will monitor the industry's implementation of the requirements to aim for AIs' full compliance.

Supervision of operational and technology risks

The SPM module in relation to the risk management of e-banking will be further updated in consultation with the banking industry. Policy guidance on other aspects of operational or technology risk management will be issued as necessary, including the periodic "Operational Incidents Watch" for sharing the operating method or control weaknesses related to significant fraud cases or

operational incidents. The HKMA will also work with the banking industry and other stakeholders to step up efforts in raising public awareness of security precautions when using electronic banking services.

A combination of risk-focused on-site examinations, and off-site surveillance and supervisory activities will be used to identify trends in operational and technology risks in the industry and the status of AIs' risk management controls. The emphasis will be on the responsibilities of AIs' boards and senior management in overseeing and managing operational and technology risks, particularly AIs that are more important to the stability and effective functioning of the monetary and banking systems of Hong Kong.

Supervision of wealth management 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 that the HKMA expects institutions to observe in the sale of investment products;
- monitor AIs' implementation of the enhanced regulatory requirements and expected practices in selling insurance products;
- continue to provide advice to the private wealth management industry and the training institutes in implementing the ECF, and monitor private banking practitioners' efforts in adopting the framework;
- continue to co-operate with the FSTB in the legislative process of establishing an independent Insurance Authority and a statutory licensing regime for insurance intermediaries; and
- continue to conduct on-site examinations and off-site surveillance of AIs' conduct in the selling of securities, MPF and other investment and insurance products, including high-yield bond products and renminbi structured products.

Banking Stability

Basel III

Capital standards

Alignment revisions arising from RCAP

Based on the findings of the Basel Committee's Regulatory Consistency Assessment Programme (RCAP) assessment on Hong Kong, the HKMA will propose amendments to the Banking (Capital) Rules (BCR) to more closely align certain provisions with the Basel capital standards, after taking into account the circumstances of the local banking sector. Industry consultation is expected to commence in the first half of 2015.

Equity investments in funds and counterparty credit risk

The Basel Committee issued three sets of final standards in 2013 and 2014: *Capital requirements for banks' equity investments in funds* (December 2013); *The standardised approach for measuring counterparty credit risk exposures* (March 2014) (revised in April 2014); and *Capital requirements for bank exposures to central counterparties* (April 2014). The first two are new standards while the last introduces revisions to the interim capital requirements issued by the Basel Committee in July 2012. All of these final standards are scheduled to come into effect on 1 January 2017. The HKMA intends to implement the final standards in accordance with the Basel Committee's timetable. Policy proposals for amendments to the BCR will be issued for industry consultation in 2015.

Disclosure standards

Under the Basel Committee's Basel III transition timetable, banks are required to make disclosures in relation to the Basel III leverage ratio, capital buffers (where applicable) and LCR starting from 1 January 2015. To facilitate the consistency and comparability of disclosures among AIs, the HKMA will issue a set of standard disclosure templates within the first half of 2015 (based on those prescribed by the Basel Committee) for AIs to make disclosures under the BDR as amended by the BDAR 2014. The HKMA will monitor AIs' disclosures to ensure they are compliant with the Basel Committee's requirements.

In the first half of 2015, the HKMA will issue for industry consultation a revised version of the "Guideline on the Application of the Banking (Disclosure) Rules" in the SPM, to update the interpretative guidance to facilitate AIs' disclosures under the BDR in the light of both the Basel III implementation and recent changes in regulatory reporting.

The HKMA also intends to consult the industry in 2015 on policy proposals for implementing the revised Pillar 3 disclosure requirements, issued by the Basel Committee in January 2015. Implementation will require amending the BDR, supplemented with the issuance of standard disclosure templates (based on those prescribed in the revised requirements by the Basel Committee) designed to facilitate consistency and comparability of disclosures among banks and across jurisdictions.

Basel III (continued)

Supplementary guidance for Basel III implementation

Following the implementation on 1 January 2015 of the provisions in the BCAR 2014 relating to the CCyB, the HKMA will —

- (a) issue the final versions of the SPM modules on "Countercyclical Capital Buffer (CCyB) – Approach to its Implementation" and "Countercyclical Capital Buffer (CCyB) – Geographic Allocation of Private Sector Credit Exposures" after incorporating feedback from the industry; and
- (b) after assessing prevailing macroprudential conditions and the extent of systemic risk build-up in Hong Kong, announce a CCyB rate applicable to private sector credit exposures in Hong Kong, which will take effect in early 2016, thus giving the banking industry one year advance notice to adjust their capital planning.

Liquidity standards

In 2015, the HKMA will focus on monitoring the implementation of the new LCR and LMR liquidity standards and completing associated work to enhance the local liquidity risk regulatory regime, including:

- (a) revision of the existing statutory guideline on "Liquidity Risk Management" (SPM LM-1) to provide supplementary guidance on the application of LCR and LMR requirements under the BLR and related Code of Practice. The relevant guidance relates, for example, to the operation of the two-tiered approach to designating category 1 and category 2 institutions; and provides further elaboration on the qualifying criteria for certain types of assets that may be recognised as HQLA under the LCR (or liquefiable assets under the LMR), and on the identification of certain types of liabilities (such as operational deposits) that may be subject to more preferential treatment under the LCR;

- (b) expansion of the existing liquidity reporting framework to support the reporting by AIs of information relating to the liquidity monitoring tools introduced by the Basel Committee to supplement the LCR and the NSFR. For this purpose, a new return on Liquidity Monitoring Tools (Form MA(BS)23) will be introduced in the course of 2015 taking into account the results of industry consultation conducted in 2014; and
- (c) development of policy proposals for the local implementation of the NSFR in consultation with the industry, taking into account the steps likely to be adopted by major overseas regulators.

In addition to the revision of the guidance relating to liquidity risk under the SPM, the approach to supervising AIs' management of their liquidity risk will also be updated under the enhanced liquidity regime.

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

SIFI framework

With the commencement on 1 January 2015 of the provisions in the BCAR 2014 relating to the designation of D-SIBs and the finalisation of the SPM module "Systemically Important Banks", the HKMA has initiated its assessment process and announced a list of D-SIBs (and their corresponding HLA capital requirements) in March 2015. The phased-in HLA capital requirements can then begin to apply to such D-SIBs starting in 2016. At present, there are no locally incorporated AIs meeting the criteria for designation as G-SIBs.

Banking Stability

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. AIs are expected to continually enhance their stress testing capability taking into account, among other things, the experience gained in the supervisor-driven stress testing programme and to better integrate their stress testing into the capital planning processes. The HKMA will continue to review the stress testing processes and capabilities through on-site visits and off-site reviews.

Co-operation with overseas supervisors

Key priorities will be to work with the crisis management groups of the internationally active banks on formulating recovery and resolution strategies and plans, and completing resolvability assessments in accordance with the timetable set by the FSB. The HKMA will seek to ensure the timely sharing of bank-specific information on prudential and other matters, including the latest developments on liquidity and solvency positions, with the overseas supervisors. With the creation of the Single Supervisory Mechanism in Europe in 2014, the HKMA aims to develop a close working relationship with the European Central Bank in its new capacity.

Recovery and resolution

The HKMA will continue to work closely with the FSTB, the SFC and the IA on proposals to establish a cross-sectoral resolution regime for financial institutions in Hong Kong. After considering submissions received in response to the second public consultation exercise, and taking into account any further developments at the international level including any guidance on recognition of cross-border resolution actions, the proposals will be further refined with a view to introducing a Bill into the Legislative Council by end-2015.

Following on from the SPM module on "Recovery Planning" issued in June 2014, a new SPM module on "Resolution Planning" is expected to be issued during 2015, following consultation with the industry. The HKMA will also continue its involvement in crisis management groups for a number of G-SIBs with sizeable operations in Hong Kong, where work is underway to develop firm-specific group-level recovery and resolution plans.

Securitisation standards

In December 2014, the Basel Committee issued *Revisions to the securitisation framework* to introduce a revised hierarchy of approaches and enhanced requirements for the calculation of regulatory capital on exposures to securitisations. The HKMA will assess the policy implications on the local securitisation framework during 2015.

Accounting standards

International regulatory developments in accounting standards will be monitored by the HKMA, including at the FSB and the Basel Committee, on the implementation of the new standard *IFRS 9* financial instruments by banks. It will also maintain contact with the HKICPA and the banking industry on the implementation of the new accounting standard on loan loss provisioning and its impact.

Development of Supervisory Policies

Credit risk transfer

The HKMA is developing a supervisory guideline to strengthen its guidance on AIs' credit risk transfer activities reflecting, among other things, international developments in the regulation of securitisations (such as disclosure requirements and measures to align incentives between originators and investors) and the reduction of reliance on external credit ratings (such as more stringent requirements for banks' internal credit assessment of securitisation exposures).

Counterparty credit risk

The SPM module "Counterparty Credit Risk Management" will be updated and brought into line with the latest capital treatment for counterparty credit risk (CCR) under the BCR. It will take into account the new standardised approach for measuring CCR introduced by the Basel Committee, as well as recent developments in CCR management practices following the global financial crisis.

Corporate governance

The FSB issued a set of *Principles for an Effective Risk Appetite Framework and Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* in November 2013 and April 2014 respectively to promote sound risk governance at financial institutions. In October 2014, the Basel Committee issued a consultative document on the revision of its *Principles for enhancing corporate governance*. The HKMA will revise the SPM module on "Corporate Governance of Locally Incorporated Authorized Institutions" to reflect these new international standards.

Total loss-absorbing capacity

In November 2014, the FSB published a consultative document on the *Adequacy of loss-absorbing capacity of global systemically important banks in resolution* in response to a call by the G20 to enhance the loss-absorbing capacity of G-SIBs in resolution. The proposals include a set of principles on the total loss-absorbing capacity (TLAC) and the recapitalisation capacity of G-SIBs in resolution, as well as a term sheet setting out a concrete proposal for implementing these principles. The HKMA will monitor developments, particularly the proposals on internal TLAC, as some AIs in Hong Kong are part of G-SIB groups.

Sound systems and controls for liquidity risk management

The HKMA intends to update the statutory guideline "Sound Systems and Controls for Liquidity Risk Management" (LM-2) in the SPM, taking into account the final form of the LCR, international developments on liquidity risk management standards, and the experience gained so far in implementing LM-2. This reflects the HKMA's strong emphasis on the development of prudent risk management systems by AIs to enhance their liquidity resilience.

Internal audit and compliance functions

The HKMA has revised the supervisory guideline "Internal Audit Function" in the SPM to incorporate the latest guidance on *The Internal Audit Function in Banks* issued by the Basel Committee in June 2012. The main areas of revision 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. The revised guideline will be issued for industry consultation during 2015. Consideration will also be given to introducing a separate supervisory guideline on the attributes of an effective compliance function.

Banking Stability

Development of Supervisory Policies (continued)

Large exposures

Following the release of the Basel Committee's enhanced large exposures regime in April 2014, the HKMA has been assessing the policy implications for the local regime. Under the new Basel standards, most exposures to single or connected counterparties will be subject to a 25% Tier 1 capital limit. A stricter 15% limit applies to exposures between G-SIBs, while intra-group exposures and exposures to sovereigns are exempted from the framework. The HKMA expects to begin consulting the industry on its proposals for local implementation of the revised standards during 2015.

To facilitate more effective monitoring of concentration risk in the form of large exposures and to prepare for the implementation of the Basel Committee's revised large exposure regime, the HKMA has developed revisions to the regulatory Return of Large Exposures. The proposed changes will require the reporting of counterparty credit risk exposures arising from foreign exchange, interest rate and other derivatives contracts. Industry consultation on the proposal was conducted in January 2015.

Guideline on OTC derivatives market reforms

Supervisory guidelines to support the phased implementation of the new regulatory framework for the OTC derivatives market in Hong Kong are being developed by the HKMA. The focus in 2015 will be on the provision of guidance for the application of mandatory clearing and related record keeping obligations, as well as of the Basel Committee/IOSCO margin requirements and IOSCO's risk mitigation standards for non-centrally cleared derivatives.

Guideline on the Supervisory Review Process

The HKMA intends to revise the scorecard relating to liquidity risk used in its SRP to accommodate the implementation of the new liquidity regime. It will also take the opportunity to update the guideline on the "Supervisory Review Process" more generally to incorporate the latest international standards, including those on capital planning processes set out in *A Sound Capital Planning Process: Fundamental Elements*, issued by the Basel Committee in January 2014.

External audits of banks

In March 2014, the Basel Committee issued revised supervisory guidance on the *External audits of banks*. The guidance aims to improve audit quality by raising the bar in relation to what supervisors expect from banks' external auditors and audit committees. The HKMA will issue updated supervisory guidance for AIs that will reflect the new international standard.

Other risk management guidance

In 2015, the HKMA expects to develop and consult the industry on a range of guidance in other areas of risk management to better align with international best practices and relevant publications issued by the Basel Committee, including market risk management and connected lending.

International co-operation

The HKMA will maintain its active involvement in the work of the Basel Committee and the FSB. This will include thematic peer reviews on resolution regimes and on other shadow banking entities which are expected to be undertaken by the FSB in 2015.

Bank consumer protection

The HKMA will continue to promote good banking practices through participation and providing advice to the Code of Banking Practice Committee. It will monitor Als' implementation of the revised Code with a progress survey in 2015 and will review Als' compliance with the Code through on-site examinations and handling complaints about products and services provided by Als.

The HKMA will monitor how the banking industry adopts specific measures to implement the Treat Customers Fairly principles in 2015. The HKMA will also consider how the effective approaches promulgated by the OECD Task Force on Financial Consumer Protection to support the implementation of the *G20 High-Level Principles on Financial Consumer Protection* can be appropriately implemented in Hong Kong.

Bank consumer education

Further initiatives will be launched under the HKMA's Consumer Education Programme, including the production of a drama series, radio broadcasts and outreach activities, to encourage the public to be smart and responsible in the use of banking services. New campaigns targeting students of tertiary institutions and secondary schools will be introduced to promote financial literacy and responsible spending. In addition, the HKMA will continue to collaborate with other stakeholders to maximise the benefits of consumer education.

Credit data sharing

The HKMA will work with the industry to promote credit data sharing, as its continued development will help strengthen the credit risk management capacity of Als.

Enforcement

More resources will be deployed to the HKMA's enforcement functions under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance. This will also involve monitoring trends related to complaints received and, where appropriate, taking prompt action to contain or mitigate potential problems.

Deposit protection

The HKMA will provide continuing support to the Hong Kong Deposit Protection Board for maintaining an effective and efficient DPS. Taking into account the IMF review and its May 2014 report on the functioning of the DPS, and the comments received in the public consultation on DPS enhancements, the conclusions of the final policy proposals will be issued, and the required legislative amendments will be prepared to implement the proposals to achieve a fast payout.

With the revised requirements on the submission of deposit records coming into force in 2015, a new independent assessment programme will be introduced to ensure that Scheme members are ready to provide the required information within the specified timeframe in accordance with the enhanced requirements. Payout simulations and a rehearsal exercise will be conducted to verify the enhanced systems and processes, as well as to ensure the HKDPB, supported by its network of service providers, is ready to make compensation to depositors swiftly in case of a bank failure. To monitor compliance with the DPS representation requirements, annual self-assessments and on-site examinations will continue. Publicity will be arranged to reinforce the public's understanding of and confidence in the protection available under the DPS.

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 codes of practice.

It will work with the FMIs on their observance of the PFMI. Assessments will be conducted, and the HKMA will continue participating in the CPMI-IOSCO PFMI implementation monitoring and assessment exercise. Where appropriate, oversight requirements will be enhanced to reflect international practices or in response to market developments.

Director Development Programme

The HKMA is committed to working with the industry to support the skills and knowledge development of directors of Als. It will monitor international developments in corporate governance practices for banks, including any recommendation by international standard-setting bodies in relation to Board qualifications, to further enhance the director development programme and, in due course, draw up best practice guidance on this subject.

International Financial Centre

Global economic growth was uneven in 2014, with a diverging pace of recovery across advanced economies and a general moderation in emerging economies. Emerging markets experienced higher volatility in the second half of the year amid a rapid strengthening of the US dollar, and net oil exporters among them were further hit by the sharp decline in oil prices. So far, emerging Asia has been less affected given its stronger fundamentals and investor differentiation of risks. But the outlook remains highly uncertain. The HKMA continued to participate in international and regional forums to contribute to global macroeconomic and financial market surveillance and the implementation of global financial regulatory reforms in a co-ordinated manner. Hong Kong's role as the premier hub for renminbi business consolidated further as renminbi activities expanded globally. Hong Kong's strong credit standing and robust fiscal performance continued to be recognised by credit rating agencies — Standard & Poor's maintained its top-rated AAA rating for Hong Kong.

OVERVIEW

The scale of clearing and settlement activities reached new highs in 2014 as the safe and efficient operation of Hong Kong's financial infrastructure, and its continued development, reinforced the city's competitive edge as a premier offshore renminbi business centre and an international financial centre. Indeed, the robustness of Hong Kong's financial infrastructure was confirmed by the International Monetary Fund in its Financial Sector Assessment Program (FSAP) report released in May. The report recognised that Hong Kong had developed a set of sophisticated multi-currency financial market infrastructure which was supported by effective oversight.

The HKMA actively contributes to international discussions on issues of significance to global and regional financial stability. In 2014, the HKMA joined the South-East Asian Central Banks (SEACEN) group, an important training and research centre for central banks in the region. It continued to chair 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+3³ authorities to strengthen the operations of the ASEAN+3 Macroeconomic

Research Office — an independent regional surveillance unit established to monitor and analyse regional economies and support decision making of the Chiang Mai Initiative Multilateralisation (CMIM)⁴.

The development of Hong Kong as the premier offshore renminbi business centre was enhanced in 2014 with the pool of renminbi deposits expanding significantly, particularly following the removal in November of the renminbi conversion limit for Hong Kong residents. Renminbi activities ranging from trade settlement, bond issuance, bank lending to payment and settlement all recorded solid growth. The continued expansion of cross-border renminbi fund flows with the Mainland, especially with the launch of the Shanghai-Hong Kong Stock Connect, is expected to further propel the development of offshore renminbi business in Hong Kong.

During the year, different components of the financial infrastructure operated smoothly. In October, the cut-off time for the renminbi settlement service in Hong Kong was further extended, facilitating timely cross-border payments through Hong Kong's renminbi settlement platform. In addition, the Central Moneymarkets Unit (CMU) system was enhanced in late 2014 to enable eligible participants to initiate renminbi intraday and overnight repo transactions with the HKMA through CMU member terminals. A new phase of the trade repository for over-the-counter (OTC) derivatives was launched in September to expand its product scope, which has enabled Hong Kong to keep pace with major overseas market reforms in the OTC derivatives market.

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.

⁴ The CMIM is a regional mechanism effective in March 2010 to provide short-term US dollar support to participants facing liquidity shortages. In May 2012, the facility was enhanced by doubling the access fund to US\$240 billion and introducing a crisis prevention facility.

International Financial Centre

REVIEW OF 2014

International and regional co-operation

With increased connections among global financial markets, the HKMA proactively fostered co-operation with other jurisdictions in promoting sustainable economic growth and financial system stability through various international and regional forums including the FSB, the Bank for International Settlements (BIS) and the Asia-Pacific Economic Co-operation (APEC). The HKMA also continued to implement global financial regulatory reforms, including the recommendations of the G20, to help strengthen the resilience of the global financial system.

The HKMA co-chaired a workshop in Hong Kong in June, which was jointly organised by the Committee on the Global Financial System (CGFS)⁵ and the FSB Standing Committee on Assessment of Vulnerabilities (SCAV)⁶. The workshop discussed current risks affecting corporate balance sheets in emerging markets, identified relevant data gaps and provided recommendations on how to address them. The workshop was attended by representatives from 28 central banks, finance ministries and international financial institutions, as well as representatives from private sector firms.

Promoting monetary and financial stability in Asia

The HKMA was admitted as a new member of SEACEN in November. It is a grouping of 20 central banks and monetary authorities in the Asia-Pacific region with a focus on research and training. By joining SEACEN, the HKMA hopes to strengthen ties with the member central banks, particularly on research and training, thereby contributing to financial and monetary stability in Hong Kong and the region.

The HKMA maintained its commitment to existing 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. It continued to prepare the Committee's half-yearly Macro-Monitoring Report to assess the region's risks and vulnerabilities and the policy implications. Private sector participants were invited to the Committee's meeting to exchange views with members on risks related to corporate leverage in Asia. Research studies were conducted on the impact on EMEAP economies of the eventual exit from unconventional monetary policies by advanced economies. The Committee also monitored the impact of the global financial regulatory reforms on Asian markets, such as the reforms on the OTC derivatives market and financial benchmarks, and facilitated the formulation of a collective regional view on issues of concern as part of its contribution to the international discussions. As one of the Deputy Chairs of the EMEAP Working Group on Payment and Settlement Systems in the first half of 2014, and the Chair since mid-2014, the HKMA worked closely with the former Chair, the People's Bank of China (PBoC), and other Deputy Chairs to co-ordinate the Working Group's effort in sharing experiences and exchanging information on risk management, oversight, standards and best practices, and developments in domestic and cross-border payment and settlement systems. The HKMA also led the Working Group's sub-group on cross-border co-operation and development.

In October, the Financial Secretary, representing the Government of the Hong Kong Special Administrative Region, signed an Agreement together with ASEAN+3 authorities to upgrade the ASEAN+3 Macroeconomic Research Office to an international organisation to support its pivotal role under the enhanced CMIM.

Hong Kong's sovereign credit ratings

The HKMA maintained close 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

⁵ The CGFS is one of the standing committees supported by the BIS with a mandate to monitor and examine broad issues relating to financial markets and the global financial system.

⁶ The SCAV is a standing committee under the FSB to identify and assess macro-financial related risks and vulnerabilities in the financial system.

rating agencies in 2014. In particular, Standard & Poor's affirmed its highest AAA rating 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 maintained Hong Kong's ratings at Aa1 and AA+ respectively, just one notch below triple-A.

Development of Hong Kong as the offshore renminbi business centre

The HKMA continued to work with the industry to strengthen Hong Kong's renminbi financial platform and promote collaboration on renminbi business with overseas markets. It also liaised with Mainland authorities on broadening channels for renminbi fund flows between the onshore and offshore markets.

The HKMA's efforts in engaging Mainland authorities on relevant policy issues contributed to important breakthroughs during the year. The Shanghai-Hong Kong Stock Connect was launched on 17 November, allowing overseas investors to invest in the Mainland A-share market through Hong Kong, and Mainland investors to trade Hong Kong shares through Shanghai. This was a milestone in the liberalisation of the Mainland's capital account, opening up a new channel for the cross-border use and circulation of renminbi. Starting from the same day, banks may conduct renminbi conversions with Hong Kong residents without applying limits. Under the new arrangement, banks square their positions arising from renminbi conversions conducted with Hong Kong residents in the offshore market instead of the onshore market. The removal of the conversion limit facilitates Hong Kong residents to participate in the Shanghai-Hong Kong Stock Connect and other renminbi financial transactions.

The HKMA introduced several measures to strengthen Hong Kong's market infrastructure for offshore renminbi business development. In October, seven banks were designated as Primary Liquidity Providers (PLPs) for a term of two years. With access to a dedicated repo facility provided by the HKMA, the designated PLPs pledged to expand their market-making activities in Hong Kong for various offshore market instruments, and to use Hong Kong as a platform in promoting their global offshore

renminbi business. In November, the HKMA started offering intraday renminbi funds of up to RMB10 billion to authorized institutions participating in renminbi business in Hong Kong to assist them in managing their renminbi liquidity and to promote efficient payment flows in Hong Kong. In the same month, the HKMA and the PBoC renewed a RMB400 billion (HK\$505 billion) currency swap agreement for another three-year term. The renewal will help the HKMA provide liquidity, when necessary, to maintain the stability of the offshore renminbi market in Hong Kong.

Hong Kong continued to expand its collaboration on renminbi business with other economies, with the HKMA facilitating the second meeting of the private sector dialogue with Australia in May and the fourth meeting with London in November. In October, the newly established Hong Kong-Thailand Renminbi Business Forum met for the first time. At the same time, the HKMA signed a Memorandum of Understanding with Banque de France to enhance co-operation on renminbi business development between Hong Kong and Paris. Through these initiatives, banks in Hong Kong strengthened their renminbi business links with their overseas counterparts and clients. Steps were also taken to increase corporate awareness of renminbi business opportunities, facilitate transfer of liquidity between different markets and provide better support for cross-market renminbi investment opportunities.



Deputy Chief Executive of the HKMA, Mr Eddie Yue [middle], moderates a panel discussion at the Second Hong Kong-Australia RMB Trade and Investment Dialogue on 22 May 2014.

International Financial Centre

Outstanding renminbi customer deposits and certificates of deposit increased by 10% to RMB1,158 billion

Renminbi trade settlement transactions handled by Hong Kong banks increased by 63% to RMB6,258 billion

Issuance of renminbi bonds increased by 69% to RMB197 billion

During 2014, outstanding renminbi customer deposits and certificates of deposit increased by 10% to RMB1,158 billion. Renminbi trade settlement transactions handled by banks in Hong Kong expanded by 63% to RMB6,258 billion. Renminbi financing activities expanded notably, with the issuance of renminbi bonds in Hong Kong amounting to RMB197 billion, 69% more than the total in 2013. The outstanding amount of renminbi bonds increased by 23% to RMB381 billion at the end of 2014. The outstanding amount of renminbi bank loans also increased by 63% to RMB188 billion. On an average day during the year, the amount of offshore renminbi foreign exchange spot and forward transactions in Hong Kong rose to some US\$30 billion equivalent, 50% higher than in 2013.

Hong Kong's renminbi RTGS system continued to support the rapid growth in the use of renminbi for financial transactions around the world. Daily turnover exceeded RMB800 billion in December, with around 90% of the transactions conducted in the offshore market. At the end of 2014, 225 banks were participating in Hong Kong's renminbi clearing platform, of which 200 were subsidiaries and branches of overseas banks or the overseas presence of Mainland banks. According to SWIFT statistics, banks in Hong Kong handled some 70% of the renminbi payments conducted with the Mainland and among the offshore markets globally.

CEPA

A new agreement to achieve basic liberalisation of trade in services between Guangdong and Hong Kong was signed in December under the framework of the Closer Economic Partnership Arrangement (CEPA). Pursuant to the new agreement, national treatment is in principle accorded to Hong Kong banks in Guangdong Province, except for differential requirements or restrictions that will be retained by way of a negative list. This will potentially provide more flexibility for Hong Kong banks to conduct business in Guangdong. In addition, the new agreement has provided for the affirmation of the established agreements on mutual recognition of banking professional qualifications, and continued efforts in promoting and expanding such arrangements.

Training

During the year, training programmes were conducted for officials from the PBoC, the State Administration of Foreign Exchange and the China Banking Regulatory Commission. These courses covered topics such as cross-border renminbi businesses, global and regional financial developments and reforms, bank risk management and compliance with regulatory requirements, consumer protection, interest rate liberalisation and financial innovation. Introductory sessions on the local banking scene and the HKMA's work were conducted for delegations from Mainland municipal governments and financial regulatory agencies. The HKMA also co-hosted a training seminar on Capital Planning and Stress Testing in Hong Kong with the Asian Development Bank, which was attended by participants from 13 APEC member economies.

Government Bond Programme (GBP)

The HKMA arranged nine tenders of institutional government bonds during the year amounting to \$20.8 billion. By the end of 2014, the total amount of outstanding institutional bonds was \$66.5 billion.

The HKMA completed a review of the local Hong Kong dollar bond market and announced in December the introduction of measures to enhance long-term development of the GBP and the Exchange Fund Bills and Notes Programme. First, the tenors of bonds issued under the two programmes were streamlined. Starting from 2015, the HKMA is only issuing new institutional government bonds with tenors of three years and above, and Exchange Fund papers with tenors of two years and below. With the cessation of any new issuance of Exchange Fund papers of three years and above, the amount of new issuances of government bonds is being increased to meet investors' demand for longer-term high-quality Hong Kong dollar bonds. As a result, the longest tenor of government bonds to be issued will be extended from 10 to 15 years. Secondly, since 15 December 2014, the HKMA has been providing a discount facility for government bonds to give banks greater flexibility to manage their liquidity. The facility provides up to a total of \$10 billion overnight liquidity against a sale and repurchase of government bonds.

Following the Government's 2014-15 Budget, the HKMA arranged in August the issuance of \$10 billion 3-year inflation-linked retail bonds (iBonds) to Hong Kong residents. It was the fourth consecutive series of iBonds issued since 2011, with the first series having matured in July 2014. The latest issue attracted over 488,000 applications with investment monies approaching \$30 billion. The amount of retail bonds outstanding at the end of the year was \$30 billion.

Inaugural issuance of US\$1 billion Government sukuk attracted order book size of over

US\$4.7 billion

Development of Islamic finance

To stimulate the further development of the Islamic bond (sukuk) market in Hong Kong, an inaugural US\$1 billion 5-year Government sukuk was successfully launched in September 2014 under the GBP.

The HKMA acted as the Government's representative in the offering, which marked the world's first US dollar-denominated sukuk originated by an AAA-rated government. It attracted strong demand from global investors, as evidenced by a significant order book size of over US\$4.7 billion. The offer was priced at 2.005% (23 basis points over 5-year US Treasuries), representing the tightest spread ever achieved on a benchmark US dollar issuance from an Asian (excluding Japan) government and setting an important new benchmark for Hong Kong and the region. The sukuk was launched following an intensive roadshow covering the Middle East, Malaysia, Hong Kong, Singapore, London and New York.

The inaugural issuance of sukuk signified an important milestone in the development of the Islamic capital market in Hong Kong, and its success proved that the issuance of sukuk using Hong Kong's platform was a viable fund-raising option and widely accepted by investors around the world. It also received international acclaims, including such awards as the Best Islamic Financing Award from *FinanceAsia* and the Best Sovereign Bond Award from *GlobalCapital Asia/Asiamoney* for 2014.

International Financial Centre

Throughout the year, the HKMA continued its efforts to strengthen ties with other Islamic financial centres and promote market knowledge and awareness of Islamic finance in Hong Kong. This included organising a number of Islamic finance conferences and seminars in collaboration with key Islamic financial centres, international Islamic organisations and local industry associations, which were well-received by the participants.

Promotion of asset management business

Promoting Hong Kong's asset management industry and reinforcing its position as a leading asset management centre is an important task for the HKMA. This requires us to provide a favourable tax and regulatory environment for these businesses. In this regard, we maintained contact 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. During 2014, the HKMA assisted the Government in preparing legislation to extend the offshore fund profits tax exemption to private equity funds, which aims to attract fund managers to expand their business in Hong Kong.

The HKMA visited asset owners, asset managers and service providers in major financial centres to highlight the latest developments in Hong Kong and to learn about their business plans for Asia. In seeking their views on potential hurdles for their operations in Hong Kong, the HKMA can know which areas of Hong Kong's financial platform could be further improved. These outreach meetings were held with private banking institutions, pension funds, mutual funds, private equity firms, hedge funds and fund administrators all over the world including Abu Dhabi, Beijing, Berlin, Boston, Dubai, Frankfurt, London, New York, San Francisco, Shanghai, Shenzhen and Singapore.

OTC derivatives market regulation

The development of a regulatory regime for the OTC derivatives market in Hong Kong entered a new stage with the Legislative Council passage of the Securities and Futures (Amendment) Ordinance 2014 last March. The legislation was the result of several years of close collaboration between the HKMA, the Financial Services and the Treasury Bureau (FSTB) and the Securities and Futures Commission (SFC) to develop a framework which aimed at reducing systemic risk and enhancing transparency in the OTC derivatives market.

The Amendment Ordinance was gazetted in April and the HKMA and the SFC have been drafting the detailed rules for implementing the new framework. In July, a first round public consultation exercise was conducted on the draft detailed rules for the mandatory reporting and related record keeping obligations. In November, the HKMA and the SFC subsequently issued the conclusions of the consultation exercise. It is hoped the rules will be finalised in 2015 H1. The HKMA has engaged the industry during the process through a number of channels, including the OTC Derivatives Market Working Group under the Treasury Markets Association (TMA) and its sub-groups, and addressed specific regulatory and infrastructural issues. In addition, the HKMA participated in several international forums, including the OTC Derivatives Working Group, established under the FSB, and the OTC Derivatives Regulators' Forum, contributing to the relevant international initiatives and monitoring closely the international regulatory developments.

Close dialogue was 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.

Development of corporate treasury centres (CTCs)

To encourage more multinational and Mainland enterprises to manage their global or regional treasury functions in Hong Kong, the Financial Secretary announced in the 2014-15 Budget the establishment of a task force to review the requirements under the Inland Revenue Ordinance for interest deductions in the taxation of corporate treasury activities, and to clarify the criteria for such deductions. The Financial Secretary announced in the 2015-16 Budget that the Government will amend the Inland Revenue Ordinance to allow, under specified conditions, interest deductions under profits tax for CTCs, and reduce profits tax for specified treasury activities by 50%. The HKMA is working with the FSTB and the Inland Revenue Department on the relevant bill, which will be introduced in the 2015-16 legislative session.

The HKMA is also consulting corporations, banks, and service providers through such organisations as the Corporate Treasury Development Working Group under the TMA, and arranging individual meetings to understand corporates' treasury operations and their views on Hong Kong's operating environment, as well as to market Hong Kong as a favourable regional destination for CTCs.

Treasury Markets Association (TMA)

The HKMA collaborates and provides necessary strategic support to the TMA in developing Hong Kong's treasury markets. The TMA's goal is 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 financial centres around the world.

At the end of 2014, the TMA had 1,560 Individual Members and 85 Institutional Members from banks, investment houses, asset managers, money brokers, financial information services providers, exchanges and large corporations. During the year, the HKMA worked closely with TMA to accomplish several important tasks:

- **Reviewed the TMA's fixings** — Because of the latest international developments on financial benchmarks, the TMA conducted a review of its fixings. Following consultation with the market, a set of more quantitative criteria was used to identify the major players in the Hong Kong dollar and offshore renminbi interbank market in Hong Kong for appointment as contributors to the HKD and CNH HIBOR respectively. In addition, the fixings that were not used by the market were phased out.
- **Continued to perform the role of administrator for Hong Kong's financial benchmarks** — The TMA maintained close contact with benchmark administrators in other markets to keep abreast of the latest surveillance methodologies used by them, and to refine, as appropriate, the methodologies used in Hong Kong. The Surveillance and Governance Committee was updated regularly on the surveillance results.
- **Co-organised the Treasury Markets Summit with the HKMA** — The Summit, on Hong Kong's role as the global hub for offshore renminbi business, was held in September. The focus was on Hong Kong's role in supporting renminbi business in other financial centres, the positioning and strategies of Hong Kong in maintaining its status as a premier offshore renminbi business hub and international asset management centre, and the opportunities and challenges brought by the development of Hong Kong as a hub for CTC.

International Financial Centre

Hong Kong's financial infrastructure

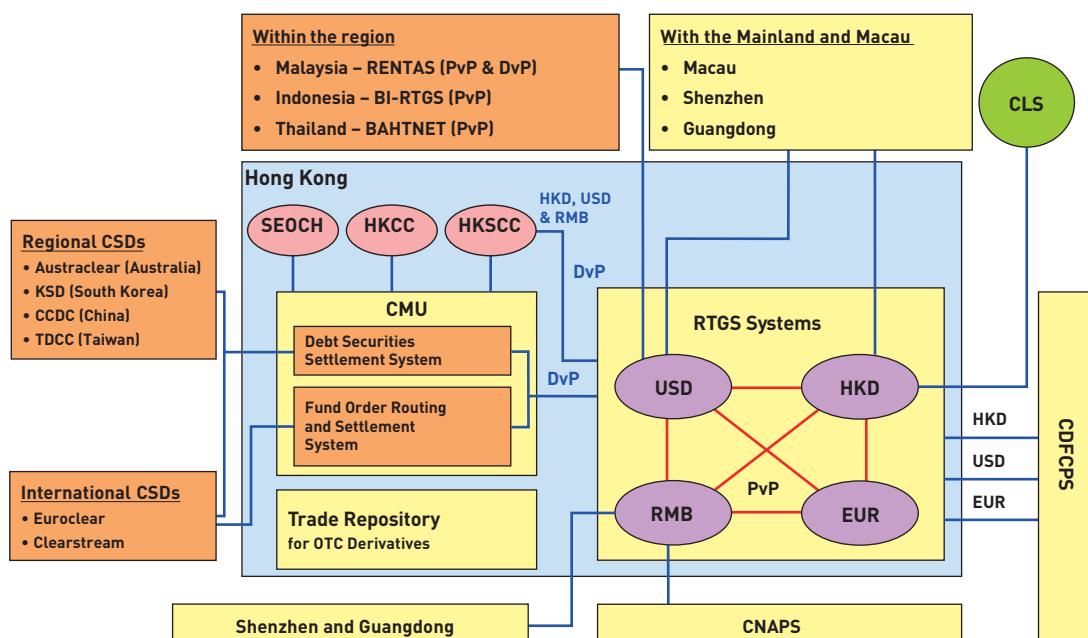
The HKMA plays a key role in developing Hong Kong's financial infrastructure to reinforce its status as a regional hub for payment and settlement of funds and securities. Each year, significant effort and resources are devoted to building a robust and efficient multi-currency, multi-dimensional platform,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

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

In response to industry demands and international developments, new components have been added to broaden the scope and increase the depth of Hong Kong's financial infrastructure. 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.

The infrastructure has been implemented in compliance with relevant international standards and best practices. Disclosure reports of Hong Kong's RTGS systems and the CMU were prepared and published in the second half of 2014, in accordance with the disclosure framework under the new international principles on financial market infrastructures jointly issued by the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO).

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



BAHTNET - Bank of Thailand Real Time Gross Settlement (Thailand's baht RTGS system)

BI-RTGS - Bank Indonesia Real Time Gross Settlement (Indonesia's rupiah RTGS system)

CCDC - China Central Depository & Clearing Co., Ltd. (settlement system for debt securities in China)

CDFCPS - China's Domestic Foreign Currency Payment System (RTGS system for foreign currency payment in China)

CLS - Continuous Linked Settlement (global multi-currency cash settlement system)

CMU - Central Moneymarkets Unit (settlement system for debt securities)

CNAPS - China National Advanced Payment System (renminbi RTGS system in China)

HKCC - HKEX Clearing Corp Ltd (central counterparty providing clearing and settlement for futures)

HKSCC - HK Securities Clearing and Co Ltd (operator of the clearing and settlement system for shares)

KSD - Korean Securities Depository (Korea's central securities depository)

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

SEOCH - SEHK Options Clearing House Ltd (central counterparty providing clearing and settlement for options)

TDCC - Taiwan Depository and Clearing Corporation (Taiwan's securities settlement system)

DvP - Delivery-versus-Payment

PvP - Payment-versus-Payment

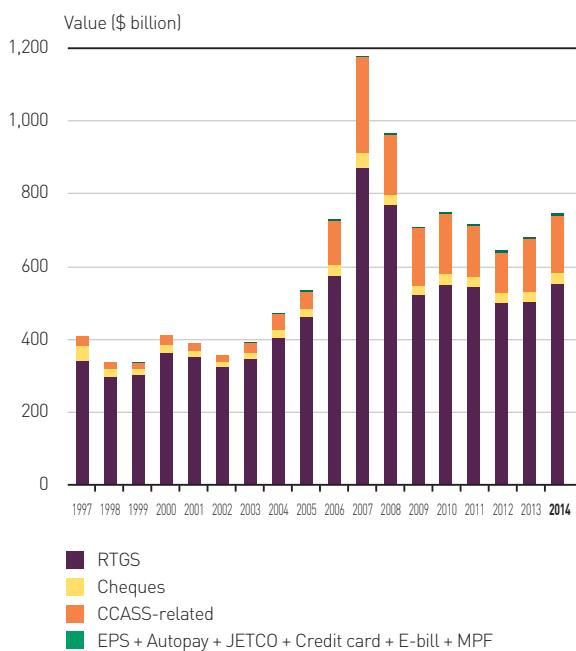
Hong Kong dollar RTGS System

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. It continued to run smoothly and efficiently in 2014. 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 jointly by the HKMA and the Hong Kong Association of Banks (HKAB). In 2014, the HKICL processed a daily average of \$558 billion in CHATS transactions (26,134 items), compared with \$507 billion (25,034 items) in 2013.

In addition to settling large-value payments, CHATS also handles daily bulk clearings of stock market transactions, MPF schemes' switching 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 repo transactions with the HKMA to settle their interbank payments.

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



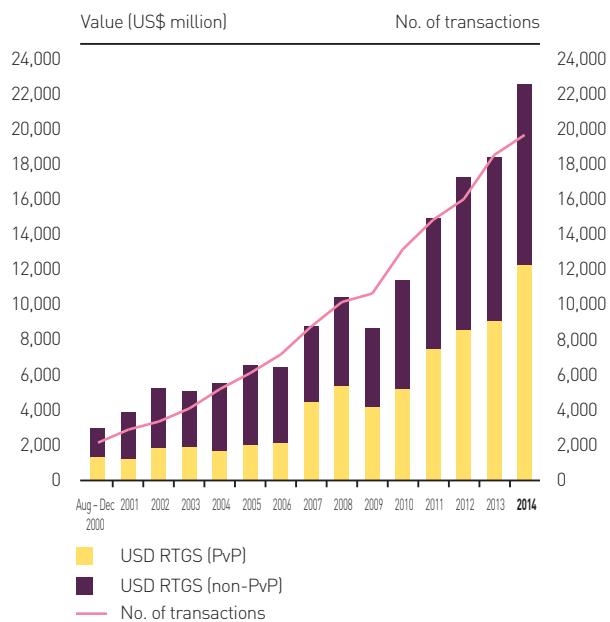
Foreign currency RTGS systems in Hong Kong

The US dollar, euro and renminbi RTGS systems all operated smoothly. Amid the rapid expansion of renminbi business in Hong Kong, the average daily turnover of the renminbi RTGS system recorded exceptional growth in 2014, rising to a daily average of RMB733 billion, nearly double the 2013 daily average of RMB395 billion. Indeed, the momentum accelerated faster in the latter part of the year with the daily average reaching RMB888 billion in December. When compared with the growth of renminbi deposits in Hong Kong, turnover in the renminbi RTGS system has been much faster, suggesting the RTGS system in Hong Kong is increasingly catering for large value money market transactions.

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 RMB4.5 billion in 2013 to RMB22.3 billion in 2014. It has come on the back of the development of renminbi business globally and the continuous momentum in the internationalisation of the renminbi.

The average daily turnover 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**



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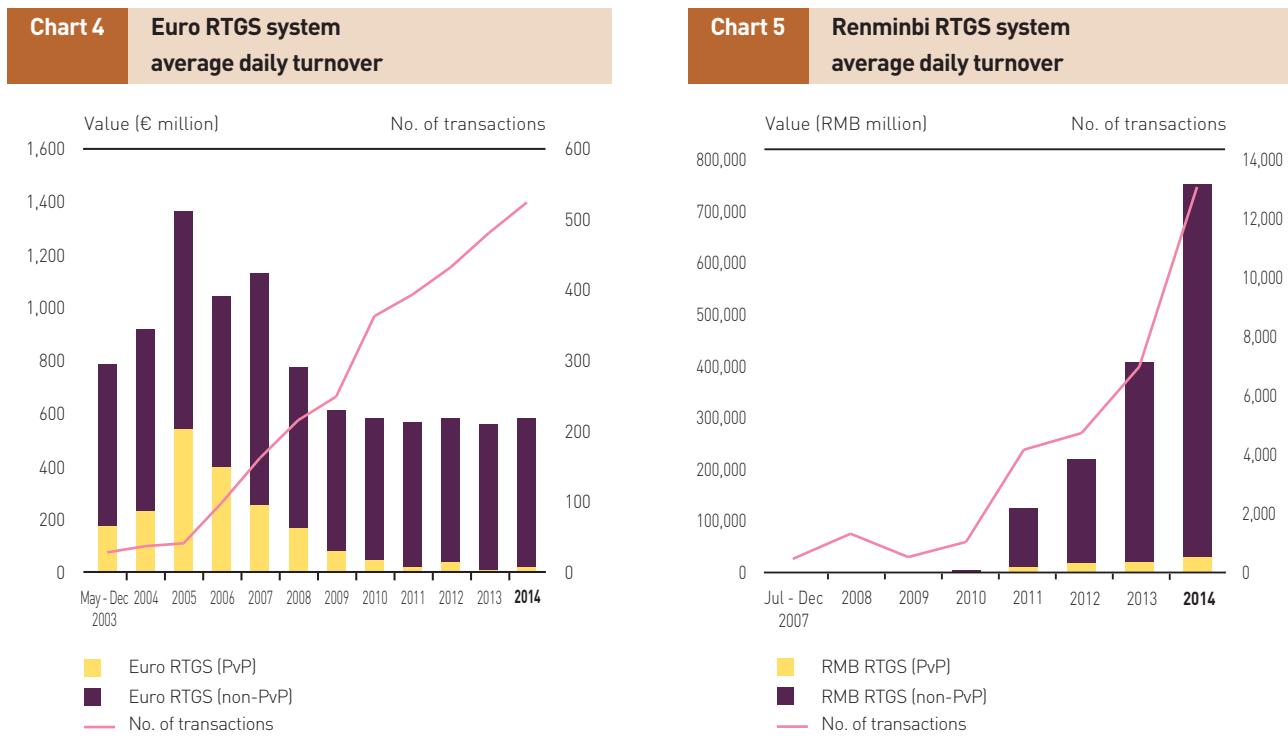


Table 1 Foreign currency RTGS systems

| RTGS systems | Launch date | Settlement institution or Clearing Bank | Number of participants at the end of 2014 | Average daily turnover in 2014 | Average daily transactions in 2014 |
|-----------------------|-------------|---|---|--------------------------------|------------------------------------|
| US dollar RTGS system | August 2000 | The Hongkong and Shanghai Banking Corporation Limited | Direct: 100 Indirect: 122 | US\$22.2 billion | 19,347 |
| Euro RTGS system | April 2003 | Standard Chartered Bank (Hong Kong) Limited | Direct: 37 Indirect: 18 | €585.0 million | 529 |
| Renminbi RTGS system | June 2007 | Bank of China (Hong Kong) Limited | Direct: 199* | RMB732.7 billion | 12,717 |

* Referring to those that have completed the registration of direct membership for the renminbi RTGS system among over 220 participating banks that have signed the Clearing Agreement with the Clearing Bank.

Payment-versus-payment (PvP)

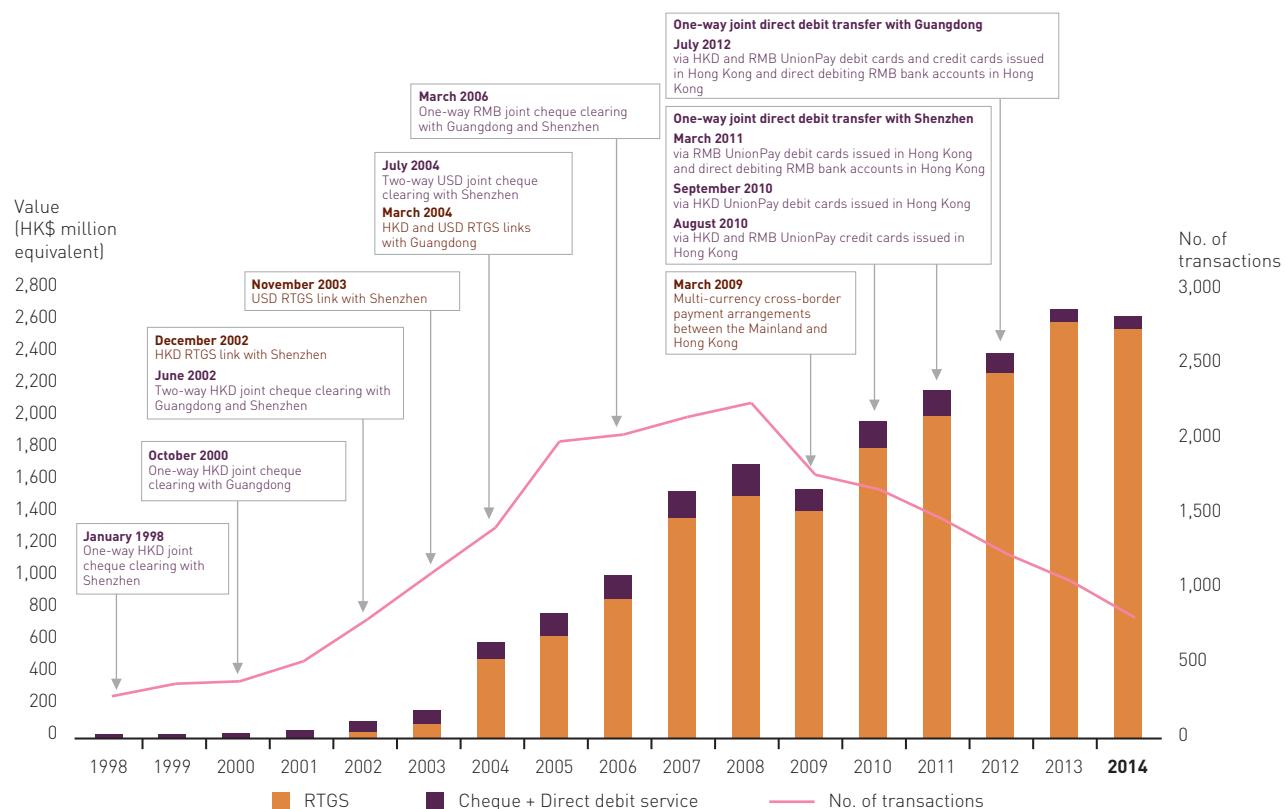
PvP is a mechanism for settling a foreign exchange transaction to ensure that payments in the two currencies involved are settled simultaneously. Within Hong Kong, six cross-currency PvP links have been established among the Hong Kong dollar, US dollar, euro and renminbi RTGS systems. Hong Kong's US dollar RTGS system has also established three cross-border PvP links, with Malaysia's ringgit RTGS system (2006), Indonesia's rupiah RTGS system (2010) and Thailand's baht RTGS system (2014). 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 2014, the transaction value of Hong Kong dollar, US dollar, euro and renminbi-related PvP transactions amounted, respectively, to about HK\$5,111 billion, US\$2,838 billion, €4 billion and RMB6,532 billion.

Payment links with the Mainland

The HKMA continues to work closely with Mainland authorities in providing efficient cross-border payment links to meet the growing demands. In 2014, the average daily turnover handled by the various system links was equivalent to \$2.6 billion, including the RTGS cross-border links with the Mainland's Domestic Foreign Currency Payment Systems launched in 2009 (Chart 6). The RTGS system links with Shenzhen and Guangdong handled more than 20,000 transactions during the year, with a total value equivalent to \$597 billion. The system allows cross-border payments in Hong Kong dollars and US dollars to be settled efficiently and safely between banks in Hong Kong and their counterparts in Shenzhen and Guangdong.

Chart 6

Average daily turnover in cross-border arrangements with the Mainland



International Financial Centre

The two-way joint cheque-clearing facilities processed about 166,000 Hong Kong dollar and US dollar cheques in 2014, with a value equivalent to \$16 billion. The facilities shorten 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 2014, renminbi cheques with a total value equivalent to around \$5 million were cleared.

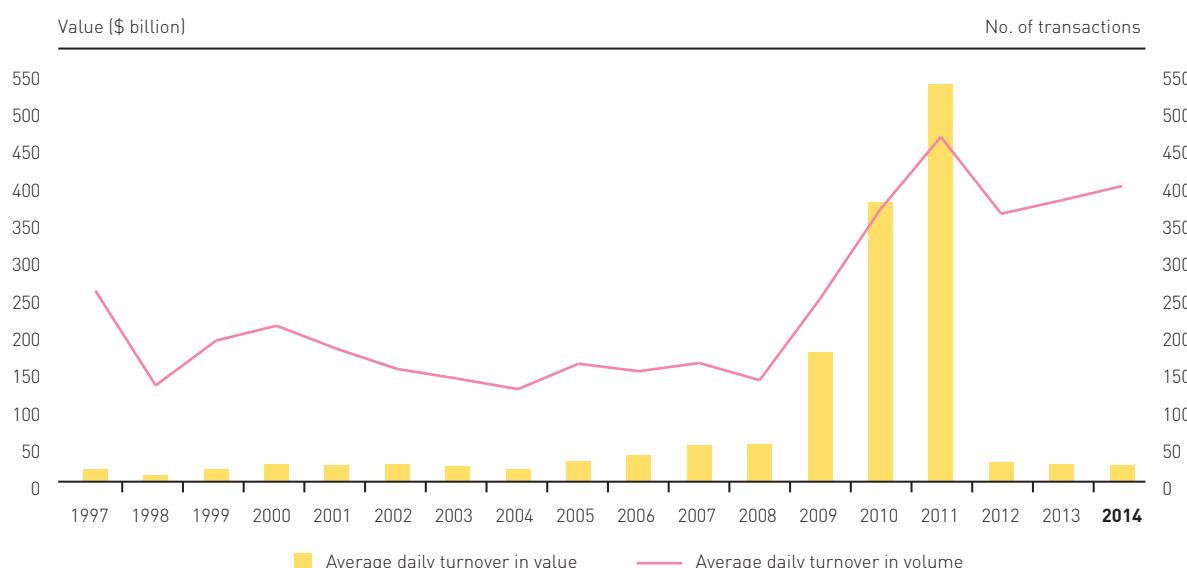
Payment links with Macau

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 of the following year. 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 2014, Hong Kong dollar cheques with a total value of about \$21 billion and US dollar cheques with a total value of about US\$25 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, while Hong Kong investors are able to hold and settle foreign securities held with CSDs outside Hong Kong. In 2014, the CMU processed an average daily value of \$22 billion (396 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 EFBNs was \$753 billion and the total amount of other debt securities was equivalent to \$1,075 billion, of which renminbi debt securities amounted to RMB407 billion.

Chart 7 CMU secondary market turnover



Financial infrastructure development

The HKMA completed a number of projects in 2014 to improve the safety and efficiency of Hong Kong's financial infrastructure, and to capture new business opportunities.

Operating hours of Hong Kong's renminbi payment service extended and enhanced provision for renminbi liquidity

To reinforce Hong Kong's role as a premier offshore renminbi centre, the operating window of Hong Kong's renminbi RTGS system was further extended in 2014, following the extension in 2012. The cut-off time of the renminbi settlement platform, as well as the cross-border renminbi payment service between Hong Kong and the Mainland, was extended in October to 5:00 a.m. the next day (Hong Kong time), providing a total of 20.5 hours for same-day value payments. The extension allows financial institutions in other parts of the world a much longer operating window to settle offshore and cross-border renminbi payments through Hong Kong's infrastructure. In November, the renminbi RTGS system was enhanced to facilitate the HKMA's provision of renminbi liquidity to the system through intraday and overnight repo transactions with eligible participants.

New cross-border PvP link established between Hong Kong and Thailand

Following close co-operation between the HKMA and the Bank of Thailand, the linkage between Hong Kong's US dollar RTGS system and Thailand's baht RTGS system was launched in July. The link can help Thai banks better manage the settlement risk of their US dollar and Thai baht (THB) foreign exchange transactions, and enhance settlement efficiency. Banks in Hong Kong can find new correspondent banking opportunities with Thai banks, thereby reinforcing Hong Kong's status as a regional payment hub. It is the third cross-border PvP link extended from Hong Kong's US dollar RTGS system.



Deputy Chief Executive of the HKMA, Mr Peter Pang (right), and Deputy Governor of Bank of Thailand, Mr Krirk Vanikkul, host the launch ceremony of the USD-THB PvP link in Hong Kong on 28 July 2014.

International Financial Centre

Intraday liquidity monitoring indicators

The Basel Committee on Banking Supervision (BCBS) issued a paper in April 2013 on *Monitoring Tools for Intraday Liquidity Management*, which requires banks to start reporting indicators on their intraday liquidity positions in 2015. The RTGS systems were enhanced in November 2014 to produce the relevant indicators to banks based on information available in the systems to support the implementation of the BCBS requirement.

Pan-Asian CSD Alliance projects

In addition to cross-border collateral management co-operation with Euroclear and J.P.Morgan, the collateral management service with Clearstream was launched in August 2014. The HKMA continues to work with global tripartite repo system operators and international CSDs to further enhance the repo market in Hong Kong.

The development of a centralised corporate action platform progressed as planned. The platform, scheduled to be launched in the second half of 2016, aims to automate and streamline the processing of corporate events of debt securities lodged with the CMU.

E-Payment for MPF transfer system

The HKMA and the Mandatory Provident Fund Schemes Authority jointly launched the e-payment for MPF transfer system in June. Making use of the CMU, the new e-payment service automates and significantly shortens the time taken to transfer Mandatory Provident Fund (MPF) accrued benefits between trustees of MPF schemes, thereby enhancing the accuracy and efficiency of the transfer process.

Investment funds mutual recognition programme

Following the launch of the Hong Kong-Shanghai Stock Connect in November, the HKMA initiated discussions with relevant authorities and industry stakeholders in both Hong Kong and on the Mainland. They aimed at exploring possible infrastructure linkages between the HKMA's CMU fund order routing platform and the related platform on the Mainland to prepare for the upcoming Hong Kong-Mainland investment fund mutual recognition programme.

CMU Central Bank Placement Co-ordinating Window

The HKMA's CMU Central Bank Placement Co-ordinating Window was again used by the Ministry of Finance for a placement of RMB2 billion offshore renminbi sovereign bonds on 21 May. The placement attracted a total subscription of RMB3.27 billion from overseas central banks and monetary authorities. Separately, and also through the HKMA's CMU bond tendering platform, the Ministry of Finance issued two batches of offshore renminbi sovereign bonds to institutional investors on 21 May and 20 November, worth RMB14 billion and RMB9 billion respectively. The increased acceptance of renminbi sovereign bonds helped expand the investor base for the offshore renminbi bond market and reinforced the role of Hong Kong as the global hub for offshore renminbi business.

New support for renminbi repo transactions

The CMU system was also enhanced in late 2014 to enable eligible CMU participants to conduct renminbi intraday and overnight repo transactions with the HKMA and initiate such transactions through CMU member terminals.

Trade repository for OTC derivatives

The second phase of the development of the local trade repository for OTC derivatives was completed in September. This phase supports the remaining most commonly traded interest rate and foreign exchange derivatives products as well as introduces equity derivatives products. Preparations were also made to support the impending commencement of mandatory reporting under the new regulatory regime for the OTC derivatives market in Hong Kong. The HKMA continued to participate in international forums and working groups on reporting standards for trade repositories to keep in view the relevant developments and ensure the local trade repository will meet international standards and best practices.

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 (EBPP) system

Banks have continued to recruit merchants to join the EBPP service since the system was launched in December 2013. One year on and the number of participating merchants had increased to 112, covering financial institutions, schools, property management companies, telecommunications operators and charity organisations. The HKMA has also supported major government billing departments in their efforts to issue bills through the EBPP platform. In addition, with the assistance of a system operator on the Mainland, the first phase of a cross-border EBPP service became available in December allowing Mainland residents to pay bills issued by Hong Kong merchants. Subsequent phases will enable Hong Kong residents to pay bills issued by Mainland merchants.

Development of e-cheque

The development of the e-cheque clearing platform and the centralised presentment portal has progressed as planned. Some 17 banks have expressed interest in offering the e-cheque service to their customers and a three-month pilot scheme is scheduled to start in December 2015. The e-cheque service will help reduce costs incurred with the manual processing of paper cheques, remove the need for physical delivery and presentment, and make the payment process safer through enhanced security features. To give e-cheques the same legal status as paper cheques, the HKMA assisted in drafting amendments to Schedule 1 of the Electronic Transactions Ordinance. The amended order becomes effective on 1 April 2015.

Near Field Communication⁷ (NFC) mobile payment

The HKMA continued to promote the awareness of NFC mobile payment to the industry and the public in Hong Kong. By the end of 2014, seven banks and a non-bank stored value card issuer had launched the NFC mobile payment service, taking into account the Best Practice for NFC Mobile Payment standards jointly developed by the HKMA and the HKAB. A technology breakthrough was also achieved in December which allows multiple payment cards, issued by different banks, to be stored on a single smart phone. In another development, an electronic funds transfer company completed the implementation of an interoperable infrastructure to enable more banks to participate in the provision of NFC mobile payment services to their customers.

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

The HKMA, the FSTB and the Department of Justice completed the drafting of the proposed legislative amendments to the Clearing and Settlement Systems Ordinance (CSSO) for the implementation of a regulatory regime for SVF and RPS. 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. Following public consultation in 2013 on the proposed regulatory regime, a consultation conclusion report was issued in October 2014. The report indicated general support for the regulatory proposals. Where appropriate, comments received from the consultation have been incorporated into the Bill to amend the CSSO, which was introduced into the Legislative Council in February 2015. In tandem with preparing the legislative amendments, the HKMA has begun formulating various supervisory guidelines and systems for the implementation of the new regulatory regime.

⁷ 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.

International Financial Centre

PLANS FOR 2015 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

Global economic growth is expected to remain uneven in 2015, leading to divergent monetary policies among major economies. The expectation of monetary normalisation in the US and the strengthening of the US dollar is likely to lead to funds outflow from emerging economies. Low oil prices, if persist for a sustained period, may also cause some net oil exporting countries and companies to experience financial difficulties and trigger broader risk aversion against emerging economies. There also appears to have been a growing disconnect between the performance of the financial markets and the real economy. While Asia generally enjoys stronger fundamentals and better macro-economic management, domestic and external imbalances have built up following years of strong credit growth and sharp asset price appreciation. The risk of an abrupt market adjustment and a reversal of capital flows cannot be ruled out, in particular if the Federal Reserve raises interest rates faster and sharper than expected. Therefore, it is important for economies to continue to enhance cross-border co-operation in market surveillance and global financial regulatory reforms to strengthen the resilience of the financial system. By participating in the various international financial and central banking forums, the HKMA is contributing to this global effort.

Hong Kong's sovereign credit ratings

The HKMA will continue its efforts to maintain 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 globally and the progressive financial liberalisation undertaken by the Mainland are expected to provide further momentum for the development of Hong Kong's offshore renminbi business. The HKMA will continue its efforts to expand Hong Kong's renminbi business links with overseas markets to capture opportunities arising from the growing scale of global renminbi activities. It will also work closely with the industry on ways to enhance the competitiveness of Hong Kong's renminbi business platform including market infrastructure. In addition, the HKMA will engage Mainland authorities to further expand the policy headroom for cross-border renminbi fund flows and closer financial co-operation between Hong Kong and the Mainland.

Market development

The HKMA will continue to participate in developing the local debt market, and, through the GBP, to broaden its investor base and enhance its liquidity. It will work closely with the private sector and industry associations to expand the range and sophistication of market products and services.

The HKMA plans to capitalise on the success of the Government's first sukuk issuance by further promoting the development of Islamic finance in Hong Kong, encouraging product development, raising market awareness and knowledge of Islamic finance, and forging 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 and regional destination for CTCs. The HKMA will reach out to the asset managers and corporate treasurers in major financial centres, promoting Hong Kong as an offshore renminbi centre, an international asset management hub, and a regional destination for CTCs.

OTC derivatives market regulation

Following passage of the Securities and Futures (Amendment) Ordinance 2014 in March, the HKMA will continue to work with the FSTB and the SFC towards developing the regulatory regime for the OTC derivatives market. Subject to the legislative process, it is expected that the regime will commence in 2015. The first stage of implementation will cover the mandatory reporting and related record keeping obligations. The HKMA and the SFC also plan to conduct public consultation on draft detailed rules for other aspects of the regime in 2015, including the mandatory clearing obligation.

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 payment hub and offshore renminbi business centre

The HKMA is actively involved in strengthening the relevant renminbi financial infrastructure to grasp the expanding business opportunities and it will continue to co-operate closely with Mainland authorities to achieve this.

Strengthening the cyber resilience of Hong Kong's RTGS systems

The HKMA will co-ordinate with the relevant parties the adoption of SWIFT's Market Infrastructure Resiliency Service (MIRS) by 2016. MIRS is a second back up site solution offering technical, operational and geographical diversity to guard against cyber attacks simultaneously affecting the production site and primary back-up site of the RTGS systems.

Cross-border mutual recognition programme of investment funds

The HKMA is working towards establishing a robust cross-border infrastructure to support the implementation of the cross-border mutual recognition programme of investment funds. It will continue to work closely with the authorities and industry stakeholders in Hong Kong and on the Mainland to develop a cost effective system solution to accomplish this important initiative.

Trade repository for OTC derivatives

The next phase of the trade repository system, to cover derivatives products in the remaining asset classes, is targeted for launch in the first half of 2016. Other new features will also be added in response to local and international regulatory requirements, for example, to support the reporting of mark-to-market valuations, and the sharing and aggregation of data.

Retail payment initiatives

The HKMA will continue its efforts to improve Hong Kong's retail payment infrastructure. Given the anticipated participation of government billing departments in the EBPP service in 2015, the HKMA plans to conduct a new round of publicity campaigns to increase public awareness of the service coverage. It will also monitor the development of the e-cheque clearing platform and centralised presentment portal which are expected to be launched in December 2015. In collaboration with the HKAB, steps will be taken to implement consumer education programmes nearer the launch date to increase public awareness of the e-cheque service.

New regulatory regime for SVF and RPS in Hong Kong

With the Clearing and Settlement Systems (Amendment) Bill 2015 introduced into the Legislative Council in February this year, the HKMA will work closely with the relevant government departments during the legislative process and continue to engage existing and potential SVF issuers and RPS operators in Hong Kong to help ensure their preparedness for the new regulatory regime.

Reserves Management

The Exchange Fund recorded an investment return of 1.4% in 2014. Amid the highly uncertain investment environment, the Investment Portfolio, which does not include contributions from the Long-Term Growth Portfolio, achieved a return of 2.0%.

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 73:27. 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 Exchange 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. Emerging market and Mainland bonds and equities are held under the Investment Portfolio while private equity and real estate investments are held under the Long-Term Growth Portfolio (LTGP). 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.

Reserves Management

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 73% 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 global 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 a number of international financial centres to manage about 27% 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 the 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 2014

The global investment environment in 2014 remained highly uncertain. Despite the end of the Federal Reserve's asset purchase programme in October and the improving US economic fundamentals, longer-term US Treasury yields went down due to concerns over global economic growth, lingering global disinflationary pressures, heightened geopolitical tensions, and, to some extent, the aggressive monetary easing of the European Central Bank and Bank of Japan. Major European government bonds led the global bond rallies, on the back of the weak economic momentum and deflation fears in Europe, as well as the European Central Bank's aggressive monetary easing policy.

On equity markets, most developed equity markets recorded gains in 2014 despite some short-lived corrections during the year, with the support of favourable investor sentiment and further accommodative monetary policies of some of the major central banks. US equities outperformed other major markets and continued to reach intermittent record highs during the year, helped by

the improving economic fundamentals in the US and the Federal Reserve's continued assurances of a prolonged low interest rate environment despite the end of asset purchases.

On currency markets, the US dollar strengthened against most major currencies in 2014, as the US was widely perceived as the global growth engine and the first major central bank to tighten its monetary policy. It appreciated particularly sharply against other major currencies going into second half of the year. The US dollar index registered the biggest single-year rise in 17 years. The euro weakened significantly in the second half of the year, dragged down by the loss in economic momentum in Europe and the European Central Bank's monetary policy accommodation. The yen also weakened substantially in late 2014, following the sluggish economic recovery in Japan after the sales tax hike in April and the Bank of Japan's additional monetary easing.

The performance of major currency, bond and equity markets in 2014 is shown in Table 1.

Table 1 2014 market returns

Currencies

| | |
|---|--------|
| Appreciation (+)/depreciation (-) against US dollar | |
| Euro | -12.2% |
| Yen | -12.3% |

Bond markets

| | |
|--|-------|
| Relevant US Government Bond (1 – 30 years) Index | +6.1% |
|--|-------|

Equity markets¹

| | |
|-----------------------------|--------|
| Standard & Poor's 500 Index | +11.4% |
| Hang Seng Index | +1.3% |

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

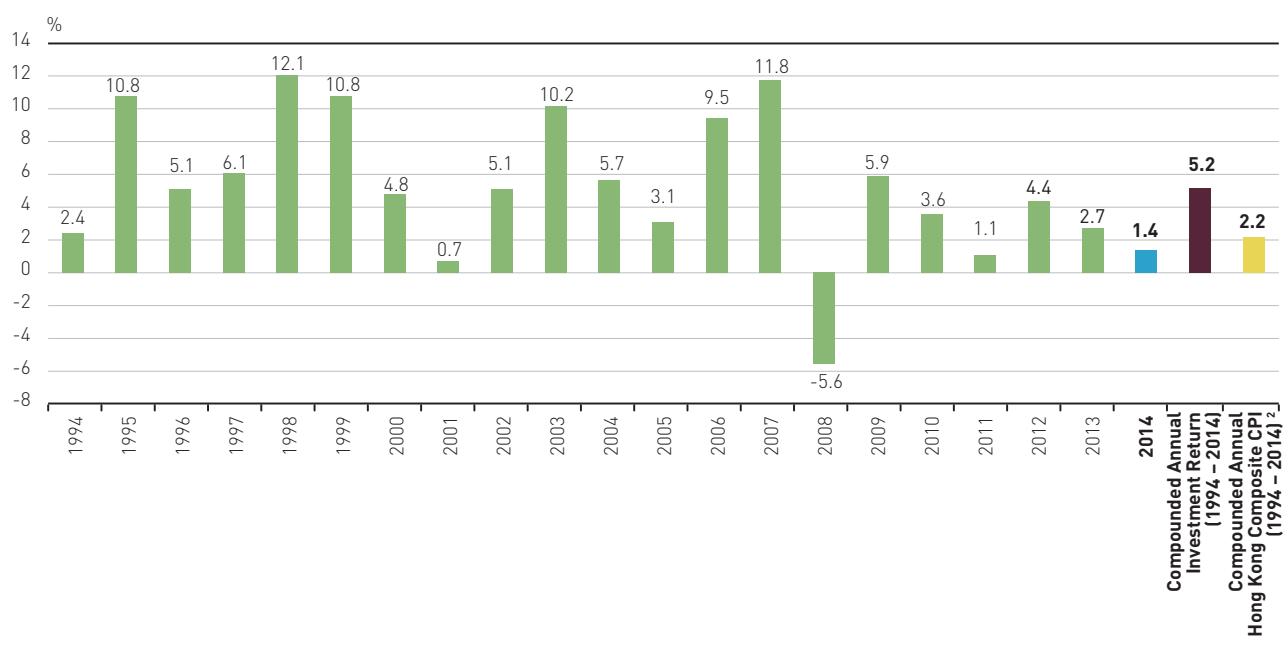
Reserves Management

The Exchange Fund's performance

The Exchange Fund recorded an investment income of \$44.7 billion in 2014, comprising a total return from bonds of \$47.3 billion, valuation gains from Hong Kong and foreign equities of \$6.5 billion and \$33.7 billion respectively, a valuation gain on other investments held by the investment holding subsidiaries of the Fund of \$9.9 billion, and an exchange valuation loss of \$52.7 billion. Apart from the \$44.7 billion investment income, the valuation gain of the Strategic Portfolio amounted to \$3.2 billion.

The investment return of the Exchange Fund after excluding the Strategic Portfolio was 1.4%. The annual return of the Fund from 1994 to 2014 is set out in Chart 1. Table 2 shows the 2014 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 2.8% over the past three years, 2.6% over the past five years, 3.7% over the past 10 years and 5.2% since 1994.¹ Table 3 shows the currency mix of the Fund's assets on 31 December 2014.

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

Chart 1**Investment return of the Exchange Fund (1994 – 2014)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 terms¹**

| | Investment return ^{2 & 3} |
|-------------------------------|--|
| 2014 | 1.4% |
| 3-year average (2012 – 2014) | 2.8% |
| 5-year average (2010 – 2014) | 2.6% |
| 10-year average (2005 – 2014) | 3.7% |
| Average since 1994 | 5.2% |

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 2014 (including forward transactions)**

| | HK\$ billion | % |
|---------------------|----------------|--------------|
| US dollar | 2,367.2 | 75.2 |
| Hong Kong dollar | 228.9 | 7.3 |
| Others ¹ | 552.9 | 17.5 |
| Total | 3,149.0 | 100.0 |

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

Corporate Functions

The HKMA maintains effective communications with the community through the media, public education programmes and various other channels to facilitate the public's understanding of its policies and operations. During the year, it continued to step up corporate governance to support various functions of the HKMA, such as through realigning organisational structure to complement strategic priorities; supporting professional development of staff; instituting rigorous financial discipline; and developing and maintaining robust IT infrastructure.

ENGAGING THE COMMUNITY CORPORATE DEVELOPMENT

Media relations

The HKMA works closely with the media to enhance the transparency of and promote public understanding about its policies and work. In 2014, 52 open press events were held, comprising 13 press conferences, nine stand-up interviews and 30 other public functions. A further 43 media interviews were arranged. A total of 389 bilingual press releases were issued and a large number of media enquiries were handled on a day-to-day basis.

In addition, the HKMA organised thematic media briefings and workshops to facilitate better understanding of the HKMA's operations and initiatives on various topics, including Mainland-related exposure of Hong Kong banking sector, HKMA's investigations into Hong Kong Interbank Offered Rate (HIBOR) fixing, anti-money laundering, and renminbi internationalisation.

Public enquiries

The Public Enquiry Service provides an effective means for the general public to obtain information from the HKMA and better understand the key functions of the organisation. It handled 8,361 enquiries in 2014.

About half of the enquiries received were related to banking policies and regulations, notes and coins, and consumer banking issues. Notable examples included banking products and services, registration of relevant individuals, prevention of money laundering and terrorist financing, and the Coin Collection Programme launched in September 2014.

Chart 1 shows the number of public enquiries received since 2011 and Chart 2 provides a breakdown by nature of the enquiries in 2014.

Chart 1 Total number of public enquiries

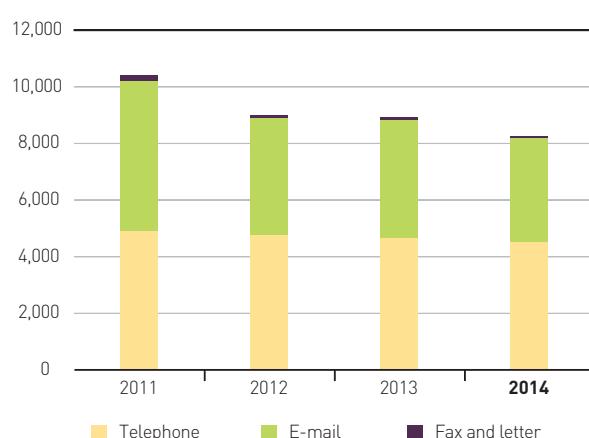
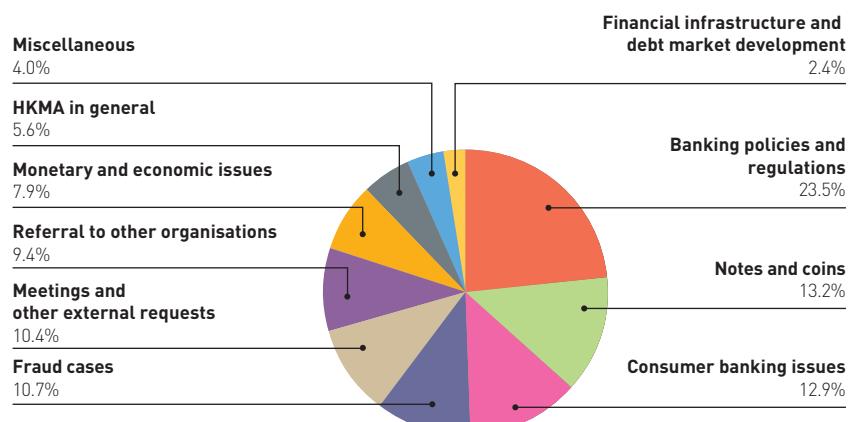


Chart 2 Nature of enquiries received in 2014



Corporate Functions

Publications

Apart from the *HKMA Annual Report*, the HKMA published 2 issues of *Half-Yearly Monetary and Financial Stability Report*, 4 issues of *Quarterly Bulletin* and released regular updates of *Monthly Statistical Bulletin* over the past year to provide up-to-date information and analyses on monetary, banking and economic issues in Hong Kong. In addition, the senior management of the HKMA published 10 *inSight* articles covering various specific and timely policy issues of the HKMA, including a series of 6 articles by the Chief Executive reviewing the past 5 years of work of the HKMA and looking ahead to the next 5 years.

The *HKMA Annual Report 2013* received a Silver award in "Non-profit Making and Charitable Organisations" Category in the Hong Kong Management Association's 2014 Best Annual Reports Awards.

The HKMA website

The HKMA corporate website (www.hkma.gov.hk), with over 50,000 pages in English and traditional and simplified Chinese, is the gateway 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.

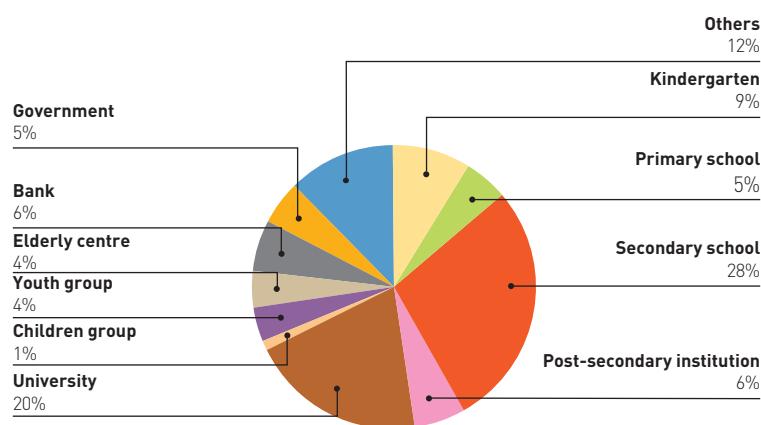
Public Education Programme

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 materials and real exhibits for study of Hong Kong's monetary, banking and financial affairs.

Guided tours of the Information Centre are organised for visitors. During the year, the Centre received more than 29,200 visitors and hosted over 480 guided tours for schools and other groups (Chart 3). Over 482,000 people have visited the Information Centre since it opened in December 2003.

The Library, situated next to the Exhibition Area, houses more than 23,000 books, journals and other publications 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 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.

To reach out to the community and raise public awareness of the HKMA's work, the HKMA continued to organise public education seminars. In 2014, three seminars were held for around 2,500 secondary school students and teachers. They covered topics such as the Linked Exchange Rate System, banknotes in Hong Kong, smart use of credit cards and the Deposit Protection Scheme. More than 52,500 people have participated in this programme since its launch in 1998.



One of the public education seminars for secondary school students and teachers.

HUMAN RESOURCES

The HKMA recruits, develops and maintains 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 workload as necessary.

Organisational changes

In March 2014, the Banking Supervision Department (BSD) realigned its resources to better focus on significant risks faced by authorized institutions individually and by the banking sector as a whole in the medium term. Under the new structure, the original five divisions were reorganised as six divisions: three subject divisions are dedicated to the supervision of corporate sector credit risk, operational and technology risk, and anti-money laundering and financial crime risk respectively, while the remaining three case management divisions are responsible for the day-to-day prudential supervision of AIs in addition to the supervision of other topical subjects such as consumer credit risk, supervisory stress testing and treasury activities.

During the year, the Deposit Protection Scheme Division, including the Settlement Section, were transferred from the Banking Conduct Department to the Enforcement Department. To further enhance governance and management efficiency, the Corporate Services Department and the Risk and Compliance Department were also put under the direct supervision of the Chief Executive.

Corporate Functions

Staffing

The establishment of the HKMA in 2014 was 816. To ensure that sufficient resources are provided to cope with the new initiatives and the increasing complexity and volume of existing work, the overall establishment of the HKMA is increased by 25 to 841 in 2015 (an increase of 3.1%). The new posts are deployed to the following functions:

- Enhancing banking and financial stability, which entails:
 - closely monitoring AIs' Mainland-related exposure;
 - conducting more in-depth financial analysis of the banking system's balance sheet;
 - implementing new supervisory requirements regarding AIs' credit and liquidity risks;
 - stepping up the supervision of AIs' various day-to-day operational risks;
 - strengthening supervisory and enforcement efforts in anti-money laundering and counter-terrorist financing; and
 - further enhancing the HKMA's macro-surveillance capability in monitoring activities in the CNH market and over-the-counter derivatives trade
- Strengthening the HKMA's risk management function in view of the growing complexity of the HKMA's investment and other activities
- Strengthening support to the expanding investment activities associated with the Long-Term Growth Portfolio
- Implementing the new statutory regime which empowers the HKMA to regulate stored value facilities and retail payment systems under the Clearing and Settlement Systems (Amendment) Bill
- Enhancing Hong Kong's status as the premier offshore RMB business centre and Asset Management Centre
- Strengthening general support in the areas of financial reporting, administration, and research.

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

Table 1 Establishment and strength of the HKMA on 1 January 2015

| Department | Functions | Senior staff | | Others | |
|--|---|---------------|-----------|---------------|------------|
| | | Establishment | Strength | Establishment | Strength |
| Chief Executive's and Deputy Chief Executives' Offices | Top management of the HKMA. | 4 | 4 | 8 | 7 |
| Banking Conduct | To focus on payment systems oversight, licensing, and all supervisory and development functions relating to the business conduct of authorized institutions. | 1 | 1 | 72 | 71 |
| Banking Policy | To formulate supervisory policies for promoting the safety and soundness of the banking sector. | 1 | 1 | 27 | 27 |
| Banking Supervision | To supervise operations of authorized institutions. | 1 | 1 | 177 | 170 |
| Enforcement | To focus on securities enforcement, complaint handling, deposit protection and settlement functions. | 1 | 1 | 89 | 83 |
| 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 | 44 | 40 |
| Financial Infrastructure | To develop and enhance the financial market infrastructure for maintaining and strengthening Hong Kong as an international financial centre. | 1 | 1 | 29 | 24 |
| 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 | 48 | 47 |
| Research | To conduct research and analysis on economic and international financial market developments in Hong Kong and other economies. | 1 | - | 40 | 38 |
| 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 | 62 | 57 |
| Risk and Compliance | To oversee all risk-generating activities, including investment risks and other non-investment related corporate risks of the HKMA. | 1 | - | 34 | 33 |
| Office of the General Counsel | To provide in-house legal support and advice. | 1 | 1 | 22 | 20 |
| 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 | 163 | 156 |
| 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 | | 16 | 14 | 825 | 783 |

Corporate Functions

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. Special pay adjustments may be made from time to time for individual meritorious staff to maintain their pay competitiveness.

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 2014 are shown in Table 2.

Table 2 Remuneration packages of HKMA senior staff in 2014¹

| \$'000 | Chief Executive | Deputy Chief Executive (average) | Executive Director (average) |
|------------------------------|-----------------|----------------------------------|------------------------------|
| Number of staff ² | 1 | 3 | 12 |
| Annualised pay | | | |
| Fixed pay | 6,125 | 6,047 | 3,649 |
| Variable pay | 2,600 | 1,783 | 912 |
| Other benefits ³ | 1,203 | 668 | 516 |

Notes:

(1) Except for annual leave accrued, the actual remuneration received by staff who did not serve out a full year is annualised for the purpose of calculating the average annual package for the rank.

(2) The number of staff at the Executive Director rank includes the Chief Executive Officer of the Hong Kong Mortgage Corporation.

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

Training and development

The HKMA attaches great importance to developing staff capabilities to meet operational demands, career development needs and new challenges. During the year, HKMA staff received training totalling 3,328 days, or on average 4.2 days per staff member. These included 1,415 days of horizontal training in general skills, and 1,913 days of vertical training in job-specific issues.

Different horizontal training programmes were run in the year. These included an annual in-house induction course for new staff on the overview of central banking and the roles and functions of the HKMA, a departmental-wide training course for banking supervision staff on cultural change to tie in with the re-structuring of the department, communication skills workshops, language courses on English writing and Putonghua, and computer skills workshops. Managerial staff also attended locally-run leadership courses conducted by the Hong Kong Government and private sectors, and national studies at Tsinghua University and China Foreign Affairs University organised by the Hong Kong Government. Other leadership programmes, including one on global finance organised by a local university, three on leadership and public policy organised by overseas and local universities and co-ordinated by the Hong Kong Government, were attended by senior and 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.

As for vertical training, various in-house courses on specific topics were organised for staff. The topics covered in the year included enhancing risk management of personal lending business, investigation and prosecution of money laundering, legal issues about regulatory litigation, legal professional privilege, leverage ratio, liquidity maintenance ratios and monitoring tools. External consultants were engaged to provide courses on US regulatory reforms, investigation skills and process sharing. Staff were also sponsored to attend courses on data protection in banking/financial services, structured trade and commodity finance, treasury market and operations, updates on insurance market and products, investment sales compliance and debt securities run by local professional bodies and training consultants.

With a view to enhancing the knowledge base and professional standards of staff, the HKMA has been running a Training Sponsorship Scheme to help staff pursue studies relevant to the work of the HKMA. The Scheme covers degree or diploma courses, professional examinations and short term courses. Reimbursement of membership fees of relevant professional bodies is also provided.

Corporate Functions

GENERAL ADMINISTRATION

The HKMA continues to streamline its work to improve efficiency and cost-effectiveness in coping with the increasing workload. Business continuity plans are reviewed regularly to ensure their effectiveness in a changing business and social environment. Drills on evacuation and the activation of back-up facilities are conducted every year to ensure the responsiveness and preparedness of various business continuity measures. A dedicated team keeps monitoring the influenza alerts and other relevant infectious diseases to ensure necessary precautionary and contingency measures are taken in accordance with the business contingency plan.

The HKMA has an established environmental policy to protect and preserve the environment. Office green measures include installing energy-saving devices, recycling, use of recycled paper and envelope, minimising printing and the use of paper products. Green achievements in 2014 included electricity saving by 3.5%, reduction in paper consumption by 14.1% and increase in collection of waste paper by 51%. Staff also continued to participate in regular campaigns for collecting clothes, toys and reusable items for donation to charities.

HKMA staff share their social responsibility and have continued to provide strong support to charity events. The HKMA Team ranked third in the Men's category in the Raleigh Wilson Trail Challenge "Adventurer – Night Course" and raised funds for supporting overseas and local youth development projects. HKMA staff took part in the Blood Donation Day, the Community Chest's Green Day, Skip Lunch Day, Dress Causal Day and Love Teeth Day.

In 2014, the HKMA Volunteer Team devoted more than 260 hours of their free time to serving the community. They participated in various volunteer services organised by the Agency of Volunteer Service, arranged visits for the students of Chak Yan Centre, joined the home visits of elderly organised by the Agency for Senior Citizen Home Safety Association, and assisted in the donation exercise on recycled computers and peripherals to Caritas Computer Workshop. In recognition of its commitment to corporate citizenship, the HKMA has been accredited with the "5 Years Plus Caring Organisation Logo" by the Hong Kong Council of Social Service.



HKMA staff members take part in the Blood Donation Day on 30 May 2014.



HKMA volunteers participate in the home visit for the elderly organised by The Agency for Senior Citizen Home Safety Association on 29 March 2014.

FINANCE

Annual budget

In drawing up the annual budget, the HKMA takes into account both its continuing operations and its strategic development set out in a three-year plan approved by the FS on the advice of EFAC. Departments are required to assess their needs for the coming year and to consider whether 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 Governance Sub-Committee of EFAC then deliberates on the budget and recommends any changes it considers necessary, before putting it through EFAC to the FS for approval.

All expenditure items are 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 2014 and the budgeted expenditure for core activities in 2015 are shown in Table 3. The difference between the 2014 actual expenditure and the 2015 budget arises mainly from an increase in staff costs, including the full-year effect of staff changes and pay review in 2014, and a net increase of 25 posts in 2015 for enhancing capabilities in the supervision of banks, internal risk control and investment activities. The headcount change for 2015 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 remain broadly stable in 2015. Spending on financial infrastructure is related to the operation and continued development of 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).

Corporate Functions

Table 3 HKMA administrative expenditure

| \$ million | 2014 Budget* | 2014 Actual | 2015 Budget* |
|--|-----------------|----------------|-----------------|
| Staff costs | | | |
| Salaries and other staff costs | | 955 | |
| Retirement benefit costs | | 86 | |
| Premises expenses | | | |
| Operating lease charges | 25 | 25 | 26 |
| Other premises expenses (including utility charges and management fees) | 57 | 53 | 59 |
| General operating costs | | | |
| Maintenance of office and computer equipment | 76 | 73 | 81 |
| Financial information and communication services (including trading, dealing terminals and data link charges) | 53 | 46 | 57 |
| External relations (including international meetings) | 53 | 34 | 63 |
| Professional and other services | 56 | 28 | 63 |
| Training | 10 | 8 | 10 |
| Others | 16 | 11 | 17 |
| Total administrative expenditure | 1,451 | 1,319 | 1,545 |

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

Table 4 Additional expenses

| \$ million | 2014 Budget* | 2014 Actual | 2015 Budget* |
|---|-----------------|----------------|-----------------|
| Subsidy to the Hong Kong Institute for Monetary Research | 22 | 18 | 17 |
| Premises expenses of international financial organisations in Hong Kong | 40 | 40 | 40 |
| Service fees for financial infrastructure | 111 | 92 | 100 |

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

In addition to investment income from managing the Exchange Fund, the HKMA collects licence fees from AIs. For 2015, revenue from licence fees is estimated at \$131 million (2014: \$131 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 applicable 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 the comprehensiveness 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 (IT) Division maintained 100% operational uptime in 2014 for all time-critical systems.

To meet the Banking Departments' evolving needs for IT support in discharging their responsibilities, a revamp of the existing banking supervisory information system was carried out. It covered three main areas, namely, new system infrastructure, development of business intelligence tools, and enhancing the existing banking return electronic submission system. The new business intelligence and workflow features will help the HKMA

oversee various supervisory issues, keep track of work targets, and ensure that supervisory work will be carried out according to procedures with clear audit trail. The project is progressing on schedule and its first phase was put into production use in December of 2014.

To implement a new regulatory regime for stored value facilities and retail payment systems, a new supervisory information system is being developed. The system covers regulated information electronic submission and data processing and downloading. It also provides various workflow features that help the HKMA process applications of regulated entities and perform supervisory and enforcement functions to ensure, with a clear audit trail, that the supervisory work will be carried out according to procedures. The system is expected to be implemented in the second half of 2015.

To ensure continued reliability of the HKMA's IT systems, ageing components of the IT infrastructure were updated in batches. The Division studied alternative office automation services and identified Virtual Desktop Infrastructure (VDI) as a suitable platform. The VDI platform was introduced in first half of 2014 involving 100 pilot users, and will gradually replace the existing decentralised office automation platform over the coming years.

IT security continued to be the Division's high priority. The IT security information and event management software provided useful early security warning to prevent possible cyber attacks. As mobile technology is changing user and business behaviours, the Division continued to explore and deploy new security arrangements for supporting staff on the move to enhance their productivity in a secure environment.

Corporate Functions

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 its settlement infrastructure to deliver greater accuracy, control and efficiency for the funds and assets transfers of the HKMA.

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 with the monetary operations and reserves management functions of the HKMA, the Section is grouped under the Enforcement 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 16 lawyers who assist the HKMA in maintaining Hong Kong's banking and monetary stability, enhancing its financial infrastructure, maintaining its status as an international financial centre, and ensuring the effective management of the Exchange Fund.

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

- implementation of the Basel III framework, including the Banking (Liquidity) Rules, the Banking (Capital) (Amendment) Rules 2014 and the draft Banking (Disclosure) (Amendment) Rules 2014
- formulation and implementation of the regulatory regime for the over-the-counter derivatives market, including the draft Securities and Futures (OTC Derivative Transactions — Reporting and Record Keeping Obligations) Rules
- formulation and implementation of the regulatory regime for retail payment systems and stored value facilities, including the draft Clearing and Settlement Systems (Amendment) Bill
- formulation of proposals with the Government and other regulators for an effective resolution regime for financial institutions in Hong Kong
- involvement in initiatives for cross-border resolution for global systemically important financial institutions, including participation in the Financial Stability Board (FSB) Resolution Steering Group, the Legal Experts Group on Cross-border Recognition of Resolution Actions and Workstream on Information Sharing for Resolution Purposes, and the provision of advice on 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

- continued development and promotion of Islamic finance initiatives, including advising on specific issues in relation to the first Government sukuk issue in September 2014
- continued development and promotion of the bond market, including implementing liquidity enhancement measures under the Institutional Bond Issuance Programme of the Government Bond Programme
- continued development and promotion of Hong Kong as a hub for corporate treasury centres, including conducting a feasibility study on issues involved in establishing a corporate treasury centre in Hong Kong
- advising on, and preparing legal documentation for, the provision of renminbi liquidity by the HKMA for the purposes of the Shanghai-Hong Kong Stock Connect which commenced operation in November 2014
- from the perspective of the HKMA, advising on and assisting in negotiations on the intergovernmental agreement between the United States and Hong Kong in relation to compliance with the US Foreign Account Tax Compliance Act by financial institutions in Hong Kong, and advising on other compliance matters under that Act
- 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 those listed above. 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 independently assesses the adequacy and effectiveness of control, risk management and governance processes, and advises on opportunities for improvement. The Division reports directly to the Chief Executive of the HKMA and the EFAC Audit Sub-Committee (ASC).

Using a risk-based approach, operational audits and system security reviews were conducted to cover all significant risk areas of the HKMA. The Division also advised on major system development projects and on internal control issues in response to requests from management and senior executives. The Division provided quarterly business risk updates to the Risk Committee, and quarterly reports to the senior executives and the ASC for audit engagement progress updates and key internal control matters.

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.

Corporate Functions

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 authorisation and controls.

Because of the growing complexity of the activities engaged by the HKMA, and the increasing public expectations of the organisation's work, the operational risk management process was strengthened in 2012. 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. 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 quarterly. This is supplemented by a top-down approach to manage entity-level risks, in which senior colleagues heading different business units 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

- Report of the Director of Audit
- Exchange Fund Financial Statements

Report of the Director of Audit



Independent Audit Report

To the Financial Secretary

I certify that I have audited the financial statements of the Exchange Fund set out on pages 130 to 219, which comprise the balance sheets of the Exchange Fund and of the Group as at 31 December 2014, and their income and expenditure accounts, statements of comprehensive income, statements of changes in equity and statements of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Monetary Authority's Responsibility for the Financial Statements

The Monetary Authority is responsible for the preparation of financial statements that give a true and fair view in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance (Cap. 66) and Hong Kong Financial Reporting Standards, and for such internal control as the Monetary Authority determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with the directive of the Chief Executive made under section 7 of the Exchange Fund Ordinance and the Audit Commission auditing standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Monetary Authority, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Report of the Director of Audit (continued)

Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Exchange Fund and of the Group as at 31 December 2014, 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

8 April 2015

Audit Commission

26th Floor

Immigration Tower

7 Gloucester Road

Wanchai, Hong Kong

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Exchange Fund – Income and Expenditure Account

for the year ended 31 December 2014

| (Expressed in millions of Hong Kong dollars) | Note | Group | | Fund | |
|--|------|-----------------|----------|-----------------|----------|
| | | 2014 | 2013 | 2014 | 2013 |
| INCOME | | | | | |
| Interest income | | 16,270 | 17,168 | 14,980 | 15,742 |
| Dividend income | | 13,498 | 11,494 | 15,250 | 11,806 |
| Income from investment properties | | 2,323 | 1,823 | – | – |
| Net realised and unrealised gains | | 68,080 | 40,000 | 61,589 | 35,287 |
| Net exchange gain/(loss) | | (51,649) | 1,420 | (52,759) | 1,555 |
| Investment income | 4(a) | 48,522 | 71,905 | 39,060 | 64,390 |
| Bank licence fees | | 131 | 131 | 131 | 131 |
| Other income | | 558 | 592 | 89 | 98 |
| TOTAL INCOME | | 49,211 | 72,628 | 39,280 | 64,619 |
| EXPENDITURE | | | | | |
| Interest expense on placements by Fiscal Reserves, HKSAR government funds and statutory bodies | 4(b) | (36,147) | (46,047) | (36,147) | (46,047) |
| Other interest expense | 4(c) | (2,110) | (1,927) | (1,418) | (1,255) |
| Operating expenses | 4(d) | (4,020) | (3,993) | (3,324) | (3,251) |
| Note and coin expenses | 4(e) | (447) | (442) | (447) | (442) |
| Write back of/[Charge for] impairment losses on loans | | (1) | 3 | – | – |
| TOTAL EXPENDITURE | | (42,725) | (52,406) | (41,336) | (50,995) |
| SURPLUS/(DEFICIT) BEFORE SHARE OF PROFIT OF ASSOCIATES AND JOINT VENTURES | | | | | |
| Share of profit of associates and joint ventures, net of tax | | 6,486 | 20,222 | (2,056) | 13,624 |
| SURPLUS/(DEFICIT) BEFORE TAXATION | | 8,216 | 20,910 | (2,056) | 13,624 |
| Income tax | 5 | (83) | (117) | – | – |
| SURPLUS/(DEFICIT) FOR THE YEAR | | 8,133 | 20,793 | (2,056) | 13,624 |
| ATTRIBUTABLE TO: | | | | | |
| Owner of the Fund | | 8,006 | 20,721 | (2,056) | 13,624 |
| Non-controlling interests | | 127 | 72 | – | – |
| | | 8,133 | 20,793 | (2,056) | 13,624 |

The notes on pages 136 to 219 form part of these financial statements.

Exchange Fund – Statement of Comprehensive Income

for the year ended 31 December 2014

| (Expressed in millions of Hong Kong dollars) | Note | Group | | Fund | |
|---|------|----------------|--------|----------------|--------|
| | | 2014 | 2013 | 2014 | 2013 |
| SURPLUS/(DEFICIT) FOR THE YEAR | | 8,133 | 20,793 | (2,056) | 13,624 |
| OTHER COMPREHENSIVE INCOME | | | | | |
| Items that may be reclassified subsequently to income and expenditure account | | | | | |
| Available-for-sale securities | | | | | |
| fair value changes on revaluation | 30 | (944) | 9,884 | – | – |
| fair value changes on disposal transferred to income and expenditure account | 30 | (63) | (296) | – | – |
| tax effect | 30 | (20) | 55 | – | – |
| Cash flow hedges | | | | | |
| fair value changes transferred to income and expenditure account | 30 | 3 | 4 | – | – |
| tax effect | 30 | – | (1) | – | – |
| Exchange differences | | | | | |
| translation of financial statements of overseas subsidiaries, associates and joint ventures | 30 | (906) | 38 | – | – |
| release of translation reserve upon disposal of a subsidiary classified as assets held for sale | 30 | (13) | – | – | – |
| OTHER COMPREHENSIVE INCOME FOR THE YEAR, NET OF TAX | | (1,943) | 9,684 | – | – |
| TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR | | 6,190 | 30,477 | (2,056) | 13,624 |
| TOTAL COMPREHENSIVE INCOME/(LOSS) FOR THE YEAR ATTRIBUTABLE TO: | | | | | |
| Owner of the Fund | | 6,079 | 30,404 | (2,056) | 13,624 |
| Non-controlling interests | | 111 | 73 | – | – |
| | | 6,190 | 30,477 | (2,056) | 13,624 |

The notes on pages 136 to 219 form part of these financial statements.

Exchange Fund – Balance Sheet

as at 31 December 2014

| (Expressed in millions of Hong Kong dollars) | Note | Group | | Fund | |
|---|-------|------------------|-----------|------------------|-----------|
| | | 2014 | 2013 | 2014 | 2013 |
| ASSETS | | | | | |
| Cash and money at call | 7 | 196,701 | 128,692 | 195,528 | 127,739 |
| Placements with banks and other financial institutions | 8 | 138,239 | 176,632 | 120,080 | 165,080 |
| Assets held for sale | 9 | – | 130 | – | – |
| Financial assets designated at fair value | 10 | 2,731,215 | 2,616,788 | 2,719,373 | 2,603,501 |
| Available-for-sale securities | 11 | 87,656 | 66,172 | 493 | 493 |
| Derivative financial instruments | 12(a) | 7,554 | 5,000 | 6,870 | 3,492 |
| Held-to-maturity securities | 13 | 9,169 | 8,624 | – | – |
| Loan portfolio | 14 | 15,572 | 22,268 | – | – |
| Gold | 15 | 621 | 622 | 621 | 622 |
| Other assets | 16 | 18,752 | 61,168 | 18,020 | 60,232 |
| Interests in subsidiaries | 17 | – | – | 84,922 | 68,545 |
| Interests in associates and joint ventures | 18 | 16,448 | 9,431 | – | – |
| Investment properties | 19 | 17,493 | 17,695 | – | – |
| Property, plant and equipment | 20(a) | 3,281 | 3,332 | 3,088 | 3,114 |
| TOTAL ASSETS | | 3,242,701 | 3,116,554 | 3,148,995 | 3,032,818 |
| LIABILITIES AND EQUITY | | | | | |
| Certificates of Indebtedness | 21 | 340,184 | 327,372 | 340,184 | 327,372 |
| Government-issued currency notes and coins in circulation | 21 | 11,028 | 10,575 | 11,028 | 10,575 |
| Balance of the banking system | 22 | 239,183 | 164,093 | 239,183 | 164,093 |
| Placements by banks and other financial institutions | 23 | 64,001 | 50,734 | 64,001 | 50,734 |
| Placements by Fiscal Reserves | 24 | 788,681 | 773,862 | 788,681 | 773,862 |
| Placements by Hong Kong Special Administrative Region government funds and statutory bodies | 25 | 261,139 | 214,911 | 261,139 | 214,911 |
| Exchange Fund Bills and Notes issued | 26 | 751,946 | 782,605 | 752,446 | 782,605 |
| Derivative financial instruments | 12(a) | 5,676 | 4,347 | 3,585 | 3,124 |
| Bank loans | 27 | 8,778 | 9,525 | – | – |
| Other debt securities issued | 28 | 33,270 | 31,335 | – | – |
| Other liabilities | 29 | 60,233 | 75,004 | 53,296 | 68,034 |
| Total liabilities | | 2,564,119 | 2,444,363 | 2,513,543 | 2,395,310 |
| Accumulated surplus | 30 | 665,995 | 657,989 | 635,452 | 637,508 |
| Revaluation reserve | 30 | 12,539 | 13,563 | – | – |
| Translation reserve | 30 | (830) | 73 | – | – |
| Total equity attributable to owner of the Fund | | 677,704 | 671,625 | 635,452 | 637,508 |
| Non-controlling interests | 30 | 878 | 566 | – | – |
| Total equity | | 678,582 | 672,191 | 635,452 | 637,508 |
| TOTAL LIABILITIES AND EQUITY | | 3,242,701 | 3,116,554 | 3,148,995 | 3,032,818 |

Norman T. L. Chan

Monetary Authority
8 April 2015

The notes on pages 136 to 219 form part of these financial statements.

Exchange Fund – Statement of Changes in Equity

for the year ended 31 December 2014

| (Expressed in millions of Hong Kong dollars) | Note | Attributable to owner of the Fund | | | | Non-controlling interests | Total |
|---|------|-----------------------------------|---------------------|---------------------|---|---------------------------|----------------|
| | | Accumulated surplus | Revaluation reserve | Translation reserve | Total attributable to owner of the Fund | | |
| Group | | | | | | | |
| At 1 January 2013 | | 637,268 | 3,917 | 36 | 641,221 | 478 | 641,699 |
| Surplus for the year | 30 | 20,721 | - | - | 20,721 | 72 | 20,793 |
| Other comprehensive income for the year | 30 | - | 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 | 30 | - | - | - | - | 38 | 38 |
| Dividends paid to non-controlling interests | 30 | - | - | - | - | (23) | (23) |
| At 31 December 2013 | | 657,989 | 13,563 | 73 | 671,625 | 566 | 672,191 |
| At 1 January 2014 | | 657,989 | 13,563 | 73 | 671,625 | 566 | 672,191 |
| Surplus for the year | 30 | 8,006 | - | - | 8,006 | 127 | 8,133 |
| Other comprehensive income for the year | 30 | - | (1,024) | (903) | (1,927) | (16) | (1,943) |
| Total comprehensive income/(loss) for the year | | 8,006 | (1,024) | (903) | 6,079 | 111 | 6,190 |
| Capital injection by non-controlling interests | 30 | - | - | - | - | 228 | 228 |
| Disposal of a subsidiary classified as assets held for sale | 30 | - | - | - | - | (13) | (13) |
| Dividends paid to non-controlling interests | 30 | - | - | - | - | (14) | (14) |
| At 31 December 2014 | | 665,995 | 12,539 | (830) | 677,704 | 878 | 678,582 |
| Fund | | | | | | | |
| At 1 January 2013 | | 623,884 | - | - | 623,884 | - | 623,884 |
| Surplus and total comprehensive income for the year | 30 | 13,624 | - | - | 13,624 | - | 13,624 |
| At 31 December 2013 | | 637,508 | - | - | 637,508 | - | 637,508 |
| At 1 January 2014 | | 637,508 | - | - | 637,508 | - | 637,508 |
| Deficit and total comprehensive loss for the year | 30 | (2,056) | - | - | (2,056) | - | (2,056) |
| At 31 December 2014 | | 635,452 | - | - | 635,452 | - | 635,452 |

The notes on pages 136 to 219 form part of these financial statements.

Exchange Fund – Statement of Cash Flows

for the year ended 31 December 2014

| (Expressed in millions of Hong Kong dollars) | Note | Group | | Fund | |
|---|-------------|------------------|-----------|------------------|-----------|
| | | 2014 | 2013 | 2014 | 2013 |
| Cash flows from operating activities | | | | | |
| Surplus/[Deficit] before taxation | | 8,216 | 20,910 | (2,056) | 13,624 |
| Adjustments for: | | | | | |
| Interest income | 4(a) | (16,270) | (17,168) | (14,980) | (15,742) |
| Dividend income | 4(a) | (13,498) | (11,494) | (15,250) | (11,806) |
| Change in fair value of investment properties | 4(a) | (1,272) | (816) | – | – |
| Net gains on disposal of available-for-sale securities | 4(a) | (6,984) | (2,590) | – | – |
| Interest expense | 4(b) & 4(c) | 38,257 | 47,974 | 37,565 | 47,302 |
| Depreciation | 4(d) | 189 | 172 | 136 | 130 |
| Share of profit of associates and joint ventures | | (1,730) | (688) | – | – |
| Gain on disposal of a subsidiary classified as assets held for sale | | (13) | – | – | – |
| Net loss on disposal of property, plant and equipment | | – | 1 | – | – |
| Elimination of exchange differences and other non-cash items | | 5,177 | (615) | 5,012 | (356) |
| Interest received | | 16,140 | 19,002 | 14,813 | 17,453 |
| Interest paid | | (10,756) | (48,011) | (10,080) | (47,336) |
| Dividends received | | 13,401 | 11,335 | 12,532 | 10,847 |
| Income tax paid | | (72) | (58) | – | – |
| | | 30,785 | 17,954 | 27,692 | 14,116 |
| Change in fair value of derivatives and other debt securities issued | | (2,288) | 1,710 | (2,924) | 2,413 |
| Change in carrying amount of: | | | | | |
| – placements with banks and other financial institutions | | (923) | (2,616) | (755) | (1,149) |
| – cash transferred to assets held for sale | | – | (129) | – | – |
| – financial assets designated at fair value | | (148,707) | (206,503) | (150,152) | (206,337) |
| – loan portfolio | | 6,696 | 3,629 | – | – |
| – gold | | 1 | 240 | 1 | 240 |
| – other assets | | 42,625 | (13,554) | 42,474 | (13,434) |
| – Certificates of Indebtedness, government-issued currency notes and coins in circulation | | 13,265 | 38,176 | 13,265 | 38,176 |
| – balance of the banking system | | 75,090 | (91,758) | 75,090 | (91,758) |
| – placements by banks and other financial institutions | | 13,267 | 50,734 | 13,267 | 50,734 |
| – placements by Fiscal Reserves | | 14,819 | 56,326 | 14,819 | 56,326 |
| – placements by Hong Kong Special Administrative Region government funds and statutory bodies | | 46,228 | 46,998 | 46,228 | 46,998 |
| – Exchange Fund Bills and Notes issued | | (30,659) | 94,391 | (30,159) | 94,121 |
| – other liabilities | | (42,226) | 42,054 | (42,214) | 42,062 |
| Net cash from operating activities | | 17,973 | 37,652 | 6,632 | 32,508 |

Exchange Fund – Statement of Cash Flows (continued)

for the year ended 31 December 2014

| (Expressed in millions of Hong Kong dollars) | Note | Group | | Fund | |
|---|------|----------|----------|----------|----------|
| | | 2014 | 2013 | 2014 | 2013 |
| Cash flows from investing activities | | | | | |
| Increase in investments in subsidiaries | | – | – | (167) | – |
| Loans to subsidiaries | | – | – | (16,210) | (12,846) |
| Increase in interests in associates and joint ventures | | (5,536) | (3,493) | – | – |
| Proceeds from sale or redemption of available-for-sale securities | | 17,983 | 12,180 | – | – |
| Purchase of available-for-sale securities | | (33,502) | (22,551) | – | – |
| Proceeds from sale or redemption of held-to-maturity securities | | 2,036 | 2,783 | – | – |
| Purchase of held-to-maturity securities | | (2,625) | (2,055) | – | – |
| Proceeds from disposal of a subsidiary classified as assets held for sale | | 117 | – | – | – |
| Purchase of property, plant and equipment | | (130) | (166) | (110) | (68) |
| Dividends received from subsidiaries | | – | – | 2,621 | 778 |
| Net cash used in investing activities | | (21,657) | (13,302) | (13,866) | (12,136) |
| Cash flows from financing activities | | | | | |
| Proceeds from issue of other debt securities | | 30,401 | 18,128 | – | – |
| Redemption of mortgage-backed securities issued | | – | (214) | – | – |
| Redemption of other debt securities issued | | (27,505) | (21,966) | – | – |
| Capital injection by non-controlling interests | | 228 | 38 | – | – |
| Dividends paid to non-controlling interests | | (14) | (23) | – | – |
| Net cash from/(used in) financing activities | | 3,110 | (4,037) | – | – |
| Net increase/(decrease) in cash and cash equivalents | | (574) | 20,313 | (7,234) | 20,372 |
| Cash and cash equivalents at 1 January | | 328,494 | 307,813 | 326,028 | 305,300 |
| Effect of foreign exchange rate changes | | (5,013) | 368 | (5,012) | 356 |
| Cash and cash equivalents at 31 December | 31 | 322,907 | 328,494 | 313,782 | 326,028 |

The notes on pages 136 to 219 form part of these financial statements.

Exchange Fund – Notes to the Financial Statements

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

1 PRINCIPAL ACTIVITIES

The Monetary Authority, under delegated authority from the Financial Secretary as Controller of the Exchange Fund (the Fund), manages the Fund in accordance with the provisions of the Exchange Fund Ordinance (Cap. 66). The principal activities of the Fund are safeguarding the exchange value of the currency of Hong Kong and maintaining the stability and integrity of Hong Kong's monetary and financial systems.

The assets of the Fund are managed as 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 32.

2 SIGNIFICANT ACCOUNTING POLICIES

2.1 Statement of compliance

These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (HKFRSs), which is a collective term that includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards (HKASs) and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (HKICPA), and accounting principles generally accepted in Hong Kong. A summary of the significant accounting policies adopted by the Fund and its subsidiaries (together referred to as the Group) is set out below.

The HKICPA has issued certain new and revised HKFRSs that are first effective or available for early adoption for the current accounting period. Note 3 provides information on the changes, if any, in accounting policies resulting from initial adoption of these developments to the extent that they are relevant to the Group for the current and prior accounting periods reflected in these financial statements.

Exchange Fund – Notes to the Financial Statements (continued)

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

2.2 Basis of preparation of the financial statements

The Group financial statements include the financial statements of the Group as well as the Group's interests in associates and joint ventures. The principal activities of the principal subsidiaries, associates and 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 38 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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).

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 interest 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 and statement of comprehensive income include 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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, interests 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 38.

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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 the 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 and other debt securities (other than those which contain embedded derivatives) issued by the Group through the HKMC.

Exchange Fund – Notes to the Financial Statements (continued)

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

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. The legally enforceable right must not be contingent on future events and must be enforceable in the normal course of business and in the event of default, insolvency or bankruptcy of the Group or the counterparty.

Exchange Fund – Notes to the Financial Statements (continued)

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

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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 of disposal. 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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 come to the attention of the Group about one or more of the following loss events which have an impact on the future cash flows of 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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 value 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 flow and income capitalisation methods.

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

Exchange Fund – Notes to the Financial Statements (continued)

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

2.14 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 |

A 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 interests in subsidiaries, interests 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 of disposal and value in use.

Exchange Fund – Notes to the Financial Statements (continued)

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

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

The results of foreign operations are translated into Hong Kong dollars at the exchange rates approximating the foreign exchange rates ruling at the dates of the transactions. Balance sheet items are translated into Hong Kong dollars at the closing foreign exchange rates at the end of the reporting period. The resulting exchange differences are recognised in other comprehensive income and accumulated separately in equity in the translation reserve.

On disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation is reclassified from equity to profit or loss when the profit or loss on disposal is recognised.

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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 Hong Kong FMI Services Limited, 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 32.

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 HKFRS 10, Consolidated Financial Statements, HKFRS 12, Disclosure of Interests in Other Entities and HKAS 27 (2011), Separate Financial Statements – Investment Entities;
- Amendments to HKAS 32, Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities;
- Amendments to HKAS 36, Impairment of Assets – Recoverable Amount Disclosures for Non-Financial Assets; and
- Amendments to HKAS 39, Financial Instruments: Recognition and Measurement – Novation of Derivatives and Continuation of Hedge Accounting.

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (note 39). Impact of the adoption of the above new or revised HKFRSs is discussed below.

Exchange Fund – Notes to the Financial Statements (continued)

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

3.1 Amendments to HKFRS 10, Consolidated Financial Statements, HKFRS 12, Disclosure of Interests in Other Entities and HKAS 27 (2011), Separate Financial Statements – Investment Entities

The amendments provide consolidation relief to those parents which qualify to be an investment entity as defined in the amended HKFRS 10. Investment entities are required to measure their subsidiaries at fair value through profit or loss. These amendments do not have any impact on the Group's financial statements as the Fund does not qualify to be an investment entity.

3.2 Amendments to HKAS 32, Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities

The amendments to HKAS 32 clarify the meaning of "currently has a legally enforceable right to set-off" and the criteria for non-simultaneous settlement mechanisms of clearing houses to qualify for offsetting. These amendments have no material impact on the Group's financial statements.

3.3 Amendments to HKAS 36, Impairment of Assets – Recoverable Amount Disclosures for Non-Financial Assets

The amendments to HKAS 36 modify the disclosure requirements for impaired non-financial assets. Among them, the amendments expand the disclosures required for an impaired asset or a cash-generating unit whose recoverable amount is based on fair value less costs of disposal. These amendments have no impact on the disclosure of the Group's financial statements.

3.4 Amendments to HKAS 39, Financial Instruments: Recognition and Measurement – Novation of Derivatives and Continuation of Hedge Accounting

The amendments to HKAS 39 introduce a relief to allow hedge accounting to continue in a situation where a derivative, which has been designated as a hedge instrument, is novated to effect clearing with a central counterparty as a result of changes in laws or regulation. These amendments have no impact on the Group's financial statements.

Exchange Fund – Notes to the Financial Statements (continued)

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

4 INCOME AND EXPENDITURE

(a) Investment income

| | Group | | Fund | |
|--|-----------------|---------|-----------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income: | | | | |
| – from derivative financial instruments | 435 | 403 | 435 | 403 |
| – from financial assets designated at fair value | 14,005 | 14,972 | 13,906 | 14,718 |
| – from other financial assets | 1,830 | 1,793 | 639 | 621 |
| | 16,270 | 17,168 | 14,980 | 15,742 |
| Dividend income: | | | | |
| – from financial assets designated at fair value | 12,933 | 11,116 | 12,618 | 11,013 |
| – from other financial assets | 565 | 378 | 11 | 15 |
| – from subsidiaries | – | – | 2,621 | 778 |
| | 13,498 | 11,494 | 15,250 | 11,806 |
| Income from investment properties: | | | | |
| – rental income | 1,051 | 1,007 | – | – |
| – change in fair value on revaluation | 1,272 | 816 | – | – |
| | 2,323 | 1,823 | – | – |
| Net realised and unrealised gains/(losses): | | | | |
| – on derivative financial instruments | (9,284) | (5,567) | (7,631) | (5,033) |
| – on financial assets and financial liabilities designated at fair value | 70,380 | 42,977 | 69,220 | 40,320 |
| – on disposal of available-for-sale securities | 6,984 | 2,590 | – | – |
| | 68,080 | 40,000 | 61,589 | 35,287 |
| Net exchange gain/(loss) | (51,649) | 1,420 | (52,759) | 1,555 |
| TOTAL | 48,522 | 71,905 | 39,060 | 64,390 |

Net realised and unrealised gains/(losses) included HK\$1,056 million loss (2013: HK\$1,188 million) on hedging instruments designated as fair value hedge and HK\$1,060 million gain (2013: HK\$1,197 million) on hedged items.

Exchange Fund – Notes to the Financial Statements (continued)

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

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

| | Group and Fund | |
|--|----------------|--------|
| | 2014 | 2013 |
| Interest on placements by Fiscal Reserves: | | |
| – at a fixed rate determined annually ¹ | 27,487 | 36,791 |
| – at market-based rates | – | 1 |
| Interest on placements by HKSAR government funds and statutory bodies: | | |
| – at a fixed rate determined annually ¹ | 8,658 | 9,253 |
| – at market-based rates | 2 | 2 |
| TOTAL | 36,147 | 46,047 |

¹ This rate was fixed at 3.6% per annum for 2014 (2013: 5%) – notes 24, 25 and 29.

(c) Other interest expense

| | Group 2014 | 2013 | Fund | |
|--|---------------|-------|--------------|-------|
| | | | 2014 | 2013 |
| Interest on Exchange Fund Bills and Notes issued | 1,389 | 1,251 | 1,389 | 1,251 |
| Interest expense on derivative financial instruments | 224 | 198 | 22 | – |
| Interest expense on other debt securities issued designated at fair value and trading liabilities | 5 | 4 | 4 | 3 |
| Interest expense on other financial liabilities | 492 | 474 | 3 | 1 |
| TOTAL | 2,110 | 1,927 | 1,418 | 1,255 |

Exchange Fund – Notes to the Financial Statements (continued)

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

(d) Operating expenses

| | Group | | Fund | |
|--|--------------|-------|--------------|-------|
| | 2014 | 2013 | 2014 | 2013 |
| Staff costs | | | | |
| Salaries and other staff costs | 1,165 | 1,093 | 955 | 910 |
| Retirement benefit costs | 98 | 91 | 86 | 80 |
| Premises and equipment expenses | | | | |
| Depreciation | 189 | 172 | 136 | 130 |
| Rental expenses under operating leases | 91 | 70 | 61 | 51 |
| Other premises expenses | 68 | 67 | 57 | 51 |
| General operating costs | | | | |
| Maintenance of office and computer equipment | 83 | 79 | 73 | 70 |
| Financial information and communication services | 53 | 54 | 46 | 48 |
| External relations | 41 | 37 | 34 | 30 |
| Service fees for financial infrastructure | 92 | 95 | 92 | 95 |
| Professional and other services | 89 | 98 | 28 | 28 |
| Training | 10 | 8 | 8 | 7 |
| Operating expenses relating to investment properties | 95 | 90 | – | – |
| Others | 37 | 26 | 29 | 30 |
| Investment management and custodian fees | | | | |
| Management and custodian fees | 1,266 | 1,287 | 1,079 | 1,058 |
| Transaction costs | 145 | 239 | 142 | 176 |
| Withholding tax | 459 | 460 | 459 | 460 |
| Others | 39 | 27 | 39 | 27 |
| TOTAL | 4,020 | 3,993 | 3,324 | 3,251 |

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

| | Group | |
|----------------|-------------|------|
| | 2014 | 2013 |
| Fixed pay | 67.3 | 65.8 |
| Variable pay | 19.5 | 17.8 |
| Other benefits | 9.3 | 9.5 |
| | 96.1 | 93.1 |

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

Exchange Fund – Notes to the Financial Statements (continued)

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

The numbers of senior staff (Executive Directors and above) of the Group whose emoluments including other benefits fell within the following bands were shown in the below table. The number of senior staff posts remained at 16. The higher figure in 2013 reflected staff movements during that year.

| HK\$ | Group | |
|-------------------------|--------------|-------------|
| | 2014 | 2013 |
| 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 | 4 | 3 |
| 4,500,001 to 5,000,000 | 3 | 1 |
| 5,000,001 to 5,500,000 | 2 | 2 |
| 5,500,001 to 6,000,000 | 1 | 2 |
| 6,000,001 to 6,500,000 | 1 | 1 |
| 6,500,001 to 7,000,000 | 1 | – |
| 7,500,001 to 8,000,000 | – | 1 |
| 8,000,001 to 8,500,000 | 2 | 2 |
| 8,500,001 to 9,000,000 | 1 | – |
| 9,500,001 to 10,000,000 | 1 | 1 |
| | 16 | 18 |

(e) Note and coin expenses

These represent reimbursements to the note-issuing banks in respect of note-issuing expenses and expenses incurred directly by the Fund in issuing government-issued currency notes and coins.

Exchange Fund – Notes to the Financial Statements (continued)

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

5 INCOME TAX

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

| | Group | | Fund | |
|---------------------------------|-------------|------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Current tax | | | | |
| Hong Kong profits tax | | | | |
| – Current year | 71 | 84 | – | – |
| – Over-provision in prior years | (10) | – | – | – |
| Taxation outside Hong Kong | | | | |
| – Current year | 9 | 9 | – | – |
| Deferred tax | | | | |
| Charge for current year | 13 | 24 | – | – |
| | 83 | 117 | – | – |

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 2014, it is calculated at 16.5% (2013: 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.

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

| | Group | | Fund | |
|--|--------------|--------|----------------|--------|
| | 2014 | 2013 | 2014 | 2013 |
| Surplus/(Deficit) before taxation | 8,216 | 20,910 | (2,056) | 13,624 |
| Surplus subject to tax in Hong Kong and elsewhere | 4,063 | 3,442 | – | – |
| Tax calculated at domestic tax rates in the respective countries | 487 | 408 | – | – |
| Tax effect of: | | | | |
| non-deductible expenses | 49 | 68 | – | – |
| non-taxable income | (463) | (326) | – | – |
| tax losses not recognised | 2 | 1 | – | – |
| over-provision in prior years | (10) | – | – | – |
| recognition of previously unrecognised deferred tax positions | – | (42) | – | – |
| others | 18 | 8 | – | – |
| Actual tax expense | 83 | 117 | – | – |

Exchange Fund – Notes to the Financial Statements (continued)

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

(b) Tax payable

| | Note | Group | | Fund | |
|-------------|------|------------|------|------|------|
| | | 2014 | 2013 | 2014 | 2013 |
| Tax payable | 29 | 151 | 155 | – | – |

(c) Deferred tax

| | Note | Group | | Fund | |
|------------------------------|------|-------------|------|------|------|
| | | 2014 | 2013 | 2014 | 2013 |
| Net deferred tax assets | 16 | (59) | {63} | – | – |
| Net deferred tax liabilities | 29 | 121 | 90 | – | – |
| | | 62 | 27 | – | – |

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

| | | Group | | | | Net deferred tax (assets)/liabilities |
|--|--|---|----------------------|------------------------------------|-----------|---------------------------------------|
| | | Adjustments on bank loans and derivative financial instruments | Fair value change | Accelerated tax depreciation | Others | |
| 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 |
| At 1 January 2014 | | (57) | 58 | 26 | – | 27 |
| Charged/[credited] to the income and expenditure account | | 1 | – | (5) | 17 | 13 |
| Charged to other comprehensive income | | – | 20 | – | – | 20 |
| Exchange differences | | 4 | – | – | (2) | 2 |
| At 31 December 2014 | | (52) | 78 | 21 | 15 | 62 |

There was no significant unprovided deferred tax as at 31 December 2014 and 2013.

Exchange Fund – Notes to the Financial Statements (continued)

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

6 CATEGORIES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

| | | | Group – 2014 | | | | | |
|---|-------|------------------|---|---|-----------------------|-----------------------------|-------------------------------|-----------------------------|
| | 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 | 196,701 | - | - | 196,701 | - | - | - |
| Placements with banks and other financial institutions | 8 | 138,239 | - | - | 138,239 | - | - | - |
| Financial assets designated at fair value | 10 | 2,731,215 | - | 2,731,215 | - | - | - | - |
| Available-for-sale securities | 11 | 87,656 | - | - | - | - | 87,656 | - |
| Derivative financial instruments | 12(a) | 7,554 | 7,554 | - | - | - | - | - |
| Held-to-maturity securities | 13 | 9,169 | - | - | - | 9,169 | - | - |
| Loan portfolio | 14 | 15,572 | - | - | 15,572 | - | - | - |
| Others | | 18,564 | - | - | 18,564 | - | - | - |
| FINANCIAL ASSETS | | 3,204,670 | 7,554 | 2,731,215 | 369,076 | 9,169 | 87,656 | - |
| Certificates of Indebtedness | 21 | 340,184 | - | - | - | - | - | 340,184 |
| Government-issued currency notes and coins in circulation | 21 | 11,028 | - | - | - | - | - | 11,028 |
| Balance of the banking system | 22 | 239,183 | - | - | - | - | - | 239,183 |
| Placements by banks and other financial institutions | 23 | 64,001 | - | - | - | - | - | 64,001 |
| Placements by Fiscal Reserves | 24 | 788,681 | - | - | - | - | - | 788,681 |
| Placements by HKSAR government funds and statutory bodies | 25 | 261,139 | - | - | - | - | - | 261,139 |
| Exchange Fund Bills and Notes issued | 26 | 751,946 | - | 751,946 | - | - | - | - |
| Derivative financial instruments | 12(a) | 5,676 | 5,676 | - | - | - | - | - |
| Bank loans | 27 | 8,778 | - | - | - | - | - | 8,778 |
| Other debt securities issued | 28 | 33,270 | - | 336 | - | - | - | 32,934 |
| Others | | 59,573 | - | - | - | - | - | 59,573 |
| FINANCIAL LIABILITIES | | 2,563,459 | 5,676 | 752,282 | - | - | - | 1,805,501 |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | | | | | 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 | 28 | 31,335 | - | 325 | - | - | - | 31,010 |
| Others | | 74,362 | - | - | - | - | - | 74,362 |
| FINANCIAL LIABILITIES | | 2,443,721 | 4,347 | 782,930 | - | - | - | 1,656,444 |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | | | | | Fund - 2014 | | | |
|---|-------|------------------|-------------------------------|---|-----------------------|-----------------------------|-------------------------------|-----------------------------|
| | 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 | 195,528 | - | - | 195,528 | - | - | - |
| Placements with banks and other financial institutions | 8 | 120,080 | - | - | 120,080 | - | - | - |
| Financial assets designated at fair value | 10 | 2,719,373 | - | 2,719,373 | - | - | - | - |
| Available-for-sale securities | 11 | 493 | - | - | - | - | 493 | - |
| Derivative financial instruments | 12(a) | 6,870 | 6,870 | - | - | - | - | - |
| Others | | 17,994 | - | - | 17,994 | - | - | - |
| FINANCIAL ASSETS | | 3,060,338 | 6,870 | 2,719,373 | 333,602 | - | 493 | - |
| Certificates of Indebtedness | 21 | 340,184 | - | - | - | - | - | 340,184 |
| Government-issued currency notes and coins in circulation | 21 | 11,028 | - | - | - | - | - | 11,028 |
| Balance of the banking system | 22 | 239,183 | - | - | - | - | - | 239,183 |
| Placements by banks and other financial institutions | 23 | 64,001 | - | - | - | - | - | 64,001 |
| Placements by Fiscal Reserves | 24 | 788,681 | - | - | - | - | - | 788,681 |
| Placements by HKSAR government funds and statutory bodies | 25 | 261,139 | - | - | - | - | - | 261,139 |
| Exchange Fund Bills and Notes issued | 26 | 752,446 | - | 752,446 | - | - | - | - |
| Derivative financial instruments | 12(a) | 3,585 | 3,585 | - | - | - | - | - |
| Others | | 53,199 | - | - | - | - | - | 53,199 |
| FINANCIAL LIABILITIES | | 2,513,446 | 3,585 | 752,446 | - | - | - | 1,757,415 |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | | | | | Fund – 2013 | | | |
|---|-------|------------------|-------------------------------|---|-----------------------|-----------------------------|-------------------------------|-----------------------------|
| | 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 | 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 |

Exchange Fund – Notes to the Financial Statements (continued)

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

7 CASH AND MONEY AT CALL

| | Group | | Fund | |
|----------------------------|----------------|---------|----------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| At amortised cost | | | | |
| Balance with central banks | 101,365 | 53,004 | 101,365 | 53,004 |
| Balance with banks | 95,336 | 75,688 | 94,163 | 74,735 |
| TOTAL | 196,701 | 128,692 | 195,528 | 127,739 |

8 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

| | Group | | Fund | |
|---|----------------|---------|----------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| At amortised cost | | | | |
| Placements in respect of reverse repurchase agreements: | | | | |
| – with central banks | 38,799 | 38,794 | 38,799 | 38,794 |
| – with banks and other financial institutions | 4,058 | 8,018 | 4,058 | 8,018 |
| Other placements: | | | | |
| – with central banks | 2,326 | – | 2,326 | – |
| – with banks | 93,056 | 129,820 | 74,897 | 118,268 |
| TOTAL | 138,239 | 176,632 | 120,080 | 165,080 |

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 in December 2013. The Group completed the sale of all its equity interest in January 2014.

Exchange Fund – Notes to the Financial Statements (continued)

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

10 FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

| | Group | | Fund | |
|--|------------------|-----------|------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| At fair value | | | | |
| Debt securities | | | | |
| Treasury bills and commercial paper | | | | |
| Listed outside Hong Kong | 17,800 | 2,325 | 17,800 | 2,325 |
| Unlisted | 701,366 | 1,075,359 | 701,366 | 1,075,359 |
| Certificates of deposit | | | | |
| Unlisted | 59,648 | 48,846 | 59,648 | 48,846 |
| Other debt securities | | | | |
| Listed outside Hong Kong | 1,176,642 | 742,967 | 1,176,586 | 742,455 |
| Unlisted | 201,428 | 221,768 | 190,860 | 211,039 |
| Total debt securities | 2,156,884 | 2,091,265 | 2,146,260 | 2,080,024 |
| Equity securities | | | | |
| Listed in Hong Kong | 156,781 | 152,895 | 156,781 | 152,895 |
| Listed outside Hong Kong | 335,606 | 297,317 | 335,606 | 297,317 |
| Unlisted | 81,944 | 75,311 | 80,726 | 73,265 |
| Total equity securities | 574,331 | 525,523 | 573,113 | 523,477 |
| TOTAL | 2,731,215 | 2,616,788 | 2,719,373 | 2,603,501 |

Exchange Fund – Notes to the Financial Statements (continued)

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

11 AVAILABLE-FOR-SALE SECURITIES

| | Group | | Fund | |
|--|---------------|--------|------------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Debt securities, at fair value | | | | |
| Listed in Hong Kong | 185 | 379 | – | – |
| Listed outside Hong Kong | 118 | 192 | – | – |
| Unlisted | 3,947 | 2,371 | – | – |
| | 4,250 | 2,942 | – | – |
| Equity securities | | | | |
| Listed in Hong Kong, at fair value | 984 | 918 | – | – |
| Unlisted, at cost | 493 | 493 | 493 | 493 |
| | 1,477 | 1,411 | 493 | 493 |
| Investment funds, at fair value | | | | |
| Unlisted | 81,929 | 61,819 | – | – |
| TOTAL | 87,656 | 66,172 | 493 | 493 |

The Group's investment in unlisted equity securities as at 31 December 2014 represents a holding of 4,285 shares (2013: 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 35). 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 37.

Exchange Fund – Notes to the Financial Statements (continued)

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

(a) Fair values of derivative financial instruments

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

| | Group | | | | Fund | | | |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | 2014 | | 2013 | | 2014 | | 2013 | |
| | Assets | Liabilities | Assets | Liabilities | Assets | Liabilities | Assets | Liabilities |
| Derivatives categorised as trading financial instruments | | | | | | | | |
| Interest rate derivatives | | | | | | | | |
| Interest rate swap contracts | 905 | 700 | 580 | 970 | 880 | 185 | 554 | 531 |
| Interest rate futures contracts | 1 | 2 | 1 | 1 | 1 | 2 | 1 | 1 |
| Equity derivatives | | | | | | | | |
| Equity contracts | 127 | - | 677 | - | - | - | - | - |
| Equity index futures contracts | 948 | 283 | 92 | 224 | 948 | 283 | 92 | 224 |
| Equity index option contracts | - | 109 | - | - | - | 109 | - | - |
| Currency derivatives | | | | | | | | |
| Forward foreign exchange contracts | 4,969 | 2,037 | 2,846 | 2,365 | 4,964 | 2,037 | 2,835 | 2,365 |
| Bond derivatives | | | | | | | | |
| Bond futures contracts | 12 | 20 | 10 | 3 | 12 | 20 | 10 | 3 |
| Bond option contracts | 65 | 949 | - | - | 65 | 949 | - | - |
| | 7,027 | 4,100 | 4,206 | 3,563 | 6,870 | 3,585 | 3,492 | 3,124 |
| Derivatives designated as hedging instruments in fair value hedges | | | | | | | | |
| Interest rate derivatives | | | | | | | | |
| Interest rate swap contracts | 511 | 10 | 632 | 24 | - | - | - | - |
| Currency derivatives | | | | | | | | |
| Currency swap contracts | 16 | 1,566 | 162 | 760 | - | - | - | - |
| | 527 | 1,576 | 794 | 784 | - | - | - | - |
| TOTAL | 7,554 | 5,676 | 5,000 | 4,347 | 6,870 | 3,585 | 3,492 | 3,124 |

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

(b) Notional amounts of derivative financial instruments

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

| | Group Notional amounts with remaining life of | | | | | | | | | |
|---|--|------------------|----------------------------------|---------------------------------|---------------|----------------|------------------|----------------------------------|---------------------------------|---------------|
| | 2014 | | | | | 2013 | | | | |
| | 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 | 74,780 | 20,623 | 26,037 | 12,398 | 15,722 | 35,880 | 300 | 1,943 | 15,756 | 17,881 |
| Interest rate futures contracts | 17,738 | 3,967 | 4,788 | 8,983 | - | 7,068 | - | 1,448 | 5,620 | - |
| Equity derivatives | | | | | | | | | | |
| Equity contracts | 938 | - | 938 | - | - | 1,068 | - | - | 1,068 | - |
| Equity index futures contracts | 101,902 | 101,902 | - | - | - | 79,951 | 79,951 | - | - | - |
| Equity index option contracts | 3,877 | 3,877 | - | - | - | - | - | - | - | - |
| Currency derivatives | | | | | | | | | | |
| Forward foreign exchange contracts | 220,576 | 155,146 | 65,430 | - | - | 306,029 | 300,962 | 2,159 | 2,908 | - |
| Bond derivatives | | | | | | | | | | |
| Bond futures contracts | 20,641 | 20,641 | - | - | - | 9,454 | 9,454 | - | - | - |
| Bond option contracts | 77,549 | - | 77,549 | - | - | - | - | - | - | - |
| | 518,001 | 306,156 | 174,742 | 21,381 | 15,722 | 439,450 | 390,667 | 5,550 | 25,352 | 17,881 |
| Derivatives designated as hedging instruments in fair value hedges | | | | | | | | | | |
| Interest rate derivatives | | | | | | | | | | |
| Interest rate swap contracts | 10,328 | 200 | 1,295 | 6,966 | 1,867 | 14,982 | 1,080 | 4,735 | 7,078 | 2,089 |
| Currency derivatives | | | | | | | | | | |
| Currency swap contracts | 18,990 | 4,829 | 6,905 | 6,478 | 778 | 16,690 | 2,313 | 7,708 | 6,588 | 81 |
| | 29,318 | 5,029 | 8,200 | 13,444 | 2,645 | 31,672 | 3,393 | 12,443 | 13,666 | 2,170 |
| TOTAL | 547,319 | 311,185 | 182,942 | 34,825 | 18,367 | 471,122 | 394,060 | 17,993 | 39,018 | 20,051 |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Fund | | | | | | | | | |
|---|---|------------------|----------------------------------|---------------------------------|---------------|----------------|------------------|----------------------------------|---------------------------------|---------------|
| | Notional amounts with remaining life of | | | | | | | | | |
| | 2014 | | | | | 2013 | | | | |
| | 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 | 64,692 | 19,775 | 25,987 | 3,330 | 15,600 | 23,790 | - | 1,000 | 8,390 | 14,400 |
| Interest rate futures contracts | 17,738 | 3,967 | 4,788 | 8,983 | - | 7,068 | - | 1,448 | 5,620 | - |
| Equity derivatives | | | | | | | | | | |
| Equity index futures contracts | 101,902 | 101,902 | - | - | - | 79,951 | 79,951 | - | - | - |
| Equity index option contracts | 3,877 | 3,877 | - | - | - | - | - | - | - | - |
| Currency derivatives | | | | | | | | | | |
| Forward foreign exchange contracts | 219,876 | 154,446 | 65,430 | - | - | 304,113 | 299,740 | 2,012 | 2,361 | - |
| Bond derivatives | | | | | | | | | | |
| Bond futures contracts | 20,641 | 20,641 | - | - | - | 9,454 | 9,454 | - | - | - |
| Bond option contracts | 77,549 | - | 77,549 | - | - | - | - | - | - | - |
| TOTAL | 506,275 | 304,608 | 173,754 | 12,313 | 15,600 | 424,376 | 389,145 | 4,460 | 16,371 | 14,400 |

13 HELD-TO-MATURITY SECURITIES

| | Group | | Fund | |
|--------------------------|--------------|-------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| At amortised cost | | | | |
| Debt securities | | | | |
| Listed in Hong Kong | 2,973 | 2,740 | - | - |
| Listed outside Hong Kong | 2,190 | 2,916 | - | - |
| Unlisted | 4,006 | 2,968 | - | - |
| TOTAL | 9,169 | 8,624 | - | - |

Fair value information of the above held-to-maturity securities is provided in note 38.2.

Exchange Fund – Notes to the Financial Statements (continued)

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

14 LOAN PORTFOLIO

| | Group | | Fund | |
|---------------------------------------|---------------|--------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Mortgage loans, at amortised cost | 14,874 | 21,455 | – | – |
| Non-mortgage loans, at amortised cost | 699 | 815 | – | – |
| Allowance for loan impairment | (1) | (2) | – | – |
| TOTAL | 15,572 | 22,268 | – | – |

15 GOLD

| | Group and Fund | |
|--|----------------|------|
| | 2014 | 2013 |
| Gold, at fair value 66,798 ounces (2013: 66,798 ounces) | 621 | 622 |

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 | |
|--|---------------|--------|---------------|--------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest and dividends receivable | 7,133 | 6,920 | 6,818 | 6,556 |
| Unsettled sales and redemption of securities | 7,329 | 45,817 | 7,329 | 45,817 |
| Prepayments, receivables and other assets | 3,652 | 7,703 | 3,294 | 7,194 |
| Staff housing loans | 120 | 138 | 120 | 138 |
| Loan to the International Monetary Fund | 459 | 527 | 459 | 527 |
| Deferred tax assets | 59 | 63 | – | – |
| TOTAL | 18,752 | 61,168 | 18,020 | 60,232 |

Exchange Fund – Notes to the Financial Statements (continued)

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

17 INTERESTS IN SUBSIDIARIES

| | Fund | |
|--------------------------|---------------|--------|
| | 2014 | 2013 |
| Unlisted shares, at cost | 2,312 | 2,145 |
| Loans to subsidiaries | 82,610 | 66,400 |
| TOTAL | 84,922 | 68,545 |

The following is a list of the principal subsidiaries held directly by the Fund as at 31 December 2014:

| 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 FMI Services Limited | Hong Kong | Performance of financial market infrastructure related operations | HK\$167,000,000 | 100% |
| The Hong Kong Mortgage Corporation Limited | Hong Kong | Investment in mortgages and loans, mortgage securitisation and guarantee | HK\$2,000,000,000 | 100% |
| Hong Kong Note Printing Limited | Hong Kong | Banknote printing | HK\$255,000,000 | 55% |
| Real Avenue Investment Company Limited | Hong Kong | Investment properties holding | HK\$1 | 100% |
| 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% |

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 6.36% and 20.18% of the Group's respective items.

Exchange Fund – Notes to the Financial Statements (continued)

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

18 INTERESTS IN ASSOCIATES AND JOINT VENTURES

| | Group | | Fund | |
|--------------------------|---------------|-------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Associates | | | | |
| Unlisted shares, at cost | – | – | – | – |
| Share of net assets | 485 | 67 | – | – |
| | 485 | 67 | – | – |
| Joint ventures | | | | |
| Share of net assets | 2,253 | 780 | – | – |
| Due from joint ventures | 13,710 | 8,584 | – | – |
| | 15,963 | 9,364 | – | – |
| TOTAL | 16,448 | 9,431 | – | – |

The Group holds investments in two associates. One of the associates is incorporated in Hong Kong which provides interbank clearing services. The other associate is incorporated outside Hong Kong which holds overseas investment properties. The Group holds equity interest in these associates ranging from 30% to 50%.

Aggregate information of the Group's associates that are not individually material is summarised below:

| | Group | |
|--|------------|------|
| | 2014 | 2013 |
| Share of profit for the year | 10 | 10 |
| Share of total comprehensive income | 10 | 10 |
| Aggregate carrying amount of interests in the associates | 485 | 67 |

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

| | Group | |
|---------------------------------|------------|------|
| | 2014 | 2013 |
| Commitments to contribute funds | 860 | – |

Exchange Fund – Notes to the Financial Statements (continued)

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

The Group holds investments in nine joint ventures, which are all incorporated outside Hong Kong. The principal activities of these joint ventures are the holding of overseas investment properties. At the end of 2014, 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 2014, the aggregate interest in these joint ventures amounted to 0.49% of the Group's total assets.

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

| | Group | |
|--|---------------|-------|
| | 2014 | 2013 |
| Share of profit for the year | 1,720 | 678 |
| Share of other comprehensive income | (247) | 4 |
| Share of total comprehensive income | 1,473 | 682 |
| Aggregate carrying amount of interests in the joint ventures | 15,963 | 9,364 |

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

| | Group | |
|---------------------------------|------------|------|
| | 2014 | 2013 |
| Commitments to contribute funds | 487 | 698 |

19 INVESTMENT PROPERTIES

| | Group | | Fund | |
|-------------------------------------|----------------|--------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| At fair value | | | | |
| At 1 January | 17,695 | 16,380 | – | – |
| Change in fair value on revaluation | 1,272 | 816 | – | – |
| Exchange differences | (1,474) | 499 | – | – |
| At 31 December | 17,493 | 17,695 | – | – |

Exchange Fund – Notes to the Financial Statements (continued)

(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 | |
|------------------------------------|---------------|--------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Held outside Hong Kong | | | | |
| on freehold | 9,077 | 9,444 | – | – |
| on long-term lease (over 50 years) | 8,416 | 8,251 | – | – |
| TOTAL | 17,493 | 17,695 | – | – |

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 | |
|---------------------|--------------|-------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Gross rental income | 1,051 | 1,007 | – | – |
| Direct expenses | (95) | (90) | – | – |
| Net rental income | 956 | 917 | – | – |

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

| | Group | | Fund | |
|---|--------------|--------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Within one year | 917 | 997 | – | – |
| After one year but not later than five years | 3,576 | 3,936 | – | – |
| After five years but not later than ten years | 3,260 | 3,871 | – | – |
| After ten years but not later than fifteen years | 1,082 | 1,855 | – | – |
| After fifteen years but not later than twenty years | – | 38 | – | – |
| TOTAL | 8,835 | 10,697 | – | – |

At 31 December 2014, investment properties with a fair value of HK\$17,493 million (2013: HK\$17,695 million) were pledged to secure general banking facilities granted to the Group (note 27).

Exchange Fund – Notes to the Financial Statements (continued)

(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 5.5% to 6.85% [2013: 4.9% to 6.1%], net initial yields which ranged from 4.89% to 4.99% (2013: 5.15% to 5.41%) and terminal capitalisation rates which ranged from 4.0% to 4.8% (2013: 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 | |
|---|----------------|--------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| At 1 January | 17,695 | 16,380 | – | – |
| Change in fair value on revaluation recognised as “income from investment properties” in the income and expenditure account | 1,272 | 816 | – | – |
| Exchange differences recognised as “net exchange gain/(loss)” in the income and expenditure account | (1,474) | 499 | – | – |
| At 31 December | 17,493 | 17,695 | – | – |
| Net gains/(losses) recognised in the income and expenditure account held at the balance sheet date | (202) | 1,315 | – | – |

Exchange Fund – Notes to the Financial Statements (continued)

(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 2013 | 3,852 | 866 | 295 | 5,013 |
| Additions | – | 130 | 36 | 166 |
| Disposals | – | [6] | – | [6] |
| At 31 December 2013 | 3,852 | 990 | 331 | 5,173 |
| At 1 January 2014 | 3,852 | 990 | 331 | 5,173 |
| Additions | – | 114 | 24 | 138 |
| Disposals | – | [36] | – | [36] |
| At 31 December 2014 | 3,852 | 1,068 | 355 | 5,275 |
| Accumulated depreciation | | | | |
| 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 |
| At 1 January 2014 | 897 | 680 | 264 | 1,841 |
| Charge for the year | 87 | 88 | 14 | 189 |
| Written back on disposal | – | [36] | – | [36] |
| At 31 December 2014 | 984 | 732 | 278 | 1,994 |
| Net book value | | | | |
| At 31 December 2014 | 2,868 | 336 | 77 | 3,281 |
| At 31 December 2013 | 2,955 | 310 | 67 | 3,332 |

Exchange Fund – Notes to the Financial Statements (continued)

(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 2013 | 3,843 | 338 | 295 | 4,476 |
| Additions | – | 32 | 36 | 68 |
| Disposals | – | [2] | – | [2] |
| At 31 December 2013 | 3,843 | 368 | 331 | 4,542 |
| At 1 January 2014 | 3,843 | 368 | 331 | 4,542 |
| Additions | – | 86 | 24 | 110 |
| Disposals | – | (6) | – | (6) |
| At 31 December 2014 | 3,843 | 448 | 355 | 4,646 |
| Accumulated depreciation | | | | |
| 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 |
| At 1 January 2014 | 892 | 272 | 264 | 1,428 |
| Charge for the year | 87 | 35 | 14 | 136 |
| Written back on disposal | – | (6) | – | (6) |
| At 31 December 2014 | 979 | 301 | 278 | 1,558 |
| Net book value | | | | |
| At 31 December 2014 | 2,864 | 147 | 77 | 3,088 |
| At 31 December 2013 | 2,951 | 96 | 67 | 3,114 |

(b) The net book value of premises comprises:

| | Group | | Fund | |
|---|--------------|-------|--------------|-------|
| | 2014 | 2013 | 2014 | 2013 |
| In Hong Kong | | | | |
| Leasehold land and the building situated thereon (leasehold between 10 and 50 years) | 2,845 | 2,932 | 2,841 | 2,928 |
| Outside Hong Kong | | | | |
| Freehold land and the building situated thereon | 23 | 23 | 23 | 23 |
| TOTAL | 2,868 | 2,955 | 2,864 | 2,951 |

Exchange Fund – Notes to the Financial Statements (continued)

(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 | |
| | 2014 | 2013 | 2014 | 2013 |
| Carrying amount | 340,184 | 327,372 | 11,028 | 10,575 |
| Reconciliation with face value: | | | | |
| Hong Kong dollar face value | 342,165 | 329,325 | 11,092 | 10,638 |
| 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\$43,867 million | US\$42,221 million | US\$1,422 million | US\$1,364 million |
| Market exchange rate for translation into Hong Kong dollars | US\$1=HK\$7.75485 | US\$1=HK\$7.75375 | US\$1=HK\$7.75485 | US\$1=HK\$7.75375 |
| Carrying amount | 340,184 | 327,372 | 11,028 | 10,575 |

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

23 PLACEMENTS BY BANKS AND OTHER FINANCIAL INSTITUTIONS

| | Group and Fund | |
|-----------------------------|----------------|--------|
| | 2014 | 2013 |
| At amortised cost | | |
| Placements by central banks | 63,171 | 50,734 |
| Placements by banks | 830 | – |
| TOTAL | 64,001 | 50,734 |

24 PLACEMENTS BY FISCAL RESERVES

| | Group and Fund | |
|---|----------------|---------|
| | 2014 | 2013 |
| Placements with interest payable at a fixed rate determined annually | | |
| General Revenue Account | 447,930 | 407,622 |
| Land Fund | 219,730 | 219,730 |
| Capital Works Reserve Fund | 67,980 | 102,467 |
| Civil Service Pension Reserve Fund | 27,029 | 27,029 |
| Disaster Relief Fund | 8 | 33 |
| Innovation and Technology Fund | 1,156 | 2,011 |
| Lotteries Fund | 21,571 | 11,173 |
| Capital Investment Fund | 2,440 | 1,929 |
| Loan Fund | 834 | 1,821 |
| | 788,678 | 773,815 |
| Placements with interest payable at market-based rates | | |
| General Revenue Account | 3 | 47 |
| TOTAL | 788,681 | 773,862 |

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 was fixed at 3.6% per annum for 2014 (2013: 5.0%). As at 31 December 2014, interest payable on these placements, included in "Other liabilities" (note 29), amounted to HK\$27.5 billion (2013: Nil).

Exchange Fund – Notes to the Financial Statements (continued)

(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 | |
|---|----------------|---------|
| | 2014 | 2013 |
| Placements with interest payable at a fixed rate¹ determined annually | | |
| Research Endowment Fund | 25,805 | 25,979 |
| Bond Fund | 112,718 | 97,303 |
| Housing Authority | 37,923 | 36,605 |
| West Kowloon Cultural District Authority | 14,930 | 14,412 |
| Trading Funds | 7,472 | 5,280 |
| Community Care Fund | 16,512 | 15,938 |
| Elite Athletes Development Fund | 6,742 | 6,595 |
| Samaritan Fund | 6,581 | 6,352 |
| Environment and Conservation Fund | 4,971 | 4,798 |
| Employees Retraining Board | 12,882 | – |
| Language Fund | 5,142 | – |
| Hospital Authority | 7,491 | – |
| | 259,169 | 213,262 |
| Placements with interest payable at market-based rates | | |
| Deposit Protection Scheme Fund | 1,970 | 1,649 |
| TOTAL | 261,139 | 214,911 |

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 was fixed at 3.6% per annum for 2014 (2013: 5.0%).

Exchange Fund – Notes to the Financial Statements (continued)

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

26 EXCHANGE FUND BILLS AND NOTES ISSUED

| | Group | | Fund | |
|---|----------------|---------|----------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| At fair value | | | | |
| Exchange Fund Bills and Notes issued | | | | |
| Exchange Fund Bills | 683,905 | 715,712 | 683,905 | 715,712 |
| Exchange Fund Notes | 69,641 | 68,892 | 69,641 | 68,892 |
| | 753,546 | 784,604 | 753,546 | 784,604 |
| Exchange Fund Bills held | (1,600) | (1,999) | (1,100) | (1,999) |
| TOTAL | 751,946 | 782,605 | 752,446 | 782,605 |

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.

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

| | Group | | | | Fund | | | |
|---|------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|
| | 2014 | | 2013 | | 2014 | | 2013 | |
| | Exchange Fund Bills | Exchange Fund Notes |
| Issued by Currency Board Operations segment | | | | | | | | |
| Nominal value at 1 January | 715,813 | 68,100 | 618,273 | 68,700 | 715,813 | 68,100 | 618,273 | 68,700 |
| Issuance | 2,128,131 | 16,400 | 2,110,221 | 16,400 | 2,128,131 | 16,400 | 2,110,221 | 16,400 |
| Redemption | (2,160,014) | (15,800) | [2,012,681] | [17,000] | (2,160,014) | (15,800) | [2,012,681] | [17,000] |
| Nominal value at 31 December | 683,930 | 68,700 | 715,813 | 68,100 | 683,930 | 68,700 | 715,813 | 68,100 |
| Long positions held by Financial Stability and Other Activities segment | | | | | | | | |
| Nominal value at 31 December | (1,600) | - | [2,000] | - | (1,100) | - | [2,000] | - |
| Total nominal value | 682,330 | 68,700 | 713,813 | 68,100 | 682,830 | 68,700 | 713,813 | 68,100 |
| Carrying amount, at fair value | 682,305 | 69,641 | 713,713 | 68,892 | 682,805 | 69,641 | 713,713 | 68,892 |
| Difference | 25 | (941) | 100 | [792] | 25 | (941) | 100 | [792] |

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

Exchange Fund – Notes to the Financial Statements (continued)

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

27 BANK LOANS

| | Group | | Fund | |
|---|--------------|-------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| At amortised cost | | | | |
| Bank loans repayable: | | | | |
| After one year but not later than two years | 1,954 | – | – | – |
| After two years but not later than five years | 6,824 | 6,248 | – | – |
| After five years but not later than ten years | – | 3,277 | – | – |
| TOTAL | 8,778 | 9,525 | – | – |

28 OTHER DEBT SECURITIES ISSUED

| | Group | | Fund | |
|---|---------------|--------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Debt securities issued, carried at amortised cost | 5,109 | 2,225 | – | – |
| Debt securities issued, designated as hedged items under fair value hedge | 27,825 | 28,785 | – | – |
| Debt securities issued, designated at fair value | 336 | 325 | – | – |
| TOTAL | 33,270 | 31,335 | – | – |

Exchange Fund – Notes to the Financial Statements (continued)

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

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

| | Group | | Fund | |
|--|-----------------|----------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Total debt securities issued | | | | |
| Nominal value at 1 January | 31,425 | 35,229 | – | – |
| Issuance | 30,468 | 18,162 | – | – |
| Redemption | (27,505) | (21,966) | – | – |
| Foreign currency translation differences | 27 | – | – | – |
| Nominal value at 31 December | 34,415 | 31,425 | – | – |
| Carrying amount | 33,270 | 31,335 | – | – |
| Difference | 1,145 | 90 | – | – |
| Debt securities issued, designated at fair value | | | | |
| Nominal value | 389 | 389 | – | – |
| Carrying amount, at fair value | 336 | 325 | – | – |
| Difference | 53 | 64 | – | – |

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

29 OTHER LIABILITIES

| | Group | | Fund | |
|--|---------------|--------|---------------|--------|
| | 2014 | 2013 | 2014 | 2013 |
| Unsettled purchases of securities | 24,902 | 67,349 | 24,902 | 67,349 |
| Interest payable on placements by Fiscal Reserves ¹ | 27,487 | – | 27,487 | – |
| Accrued charges and other liabilities | 7,219 | 6,990 | 741 | 508 |
| Other interest payable | 353 | 420 | 166 | 177 |
| Tax payable | 151 | 155 | – | – |
| Deferred tax liabilities | 121 | 90 | – | – |
| TOTAL | 60,233 | 75,004 | 53,296 | 68,034 |

¹ In accordance with a directive made by the Financial Secretary in December 2014, the accrued interest on placements by Fiscal Reserves earned for the year shall not be payable on 31 December 2014. The arrangement is intended to earmark for the establishment of a Housing Reserve a sum which may be made available for appropriation under the Public Finance Ordinance for the purpose of financing the development of public housing and public housing-related projects and infrastructure. The sum shall earn interest at the fixed rate [note 24] and shall be payable to the fund accounts of the Fiscal Reserves on a date determined by the Financial Secretary.

Exchange Fund – Notes to the Financial Statements (continued)

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

30 EQUITY

| | Group | | Fund | |
|---|----------------|---------|----------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| Attributable to owner of the Fund | | | | |
| Accumulated surplus | | | | |
| At 1 January | 657,989 | 637,268 | 637,508 | 623,884 |
| Surplus/(Deficit) for the year | 8,006 | 20,721 | (2,056) | 13,624 |
| At 31 December | 665,995 | 657,989 | 635,452 | 637,508 |
| Revaluation reserve | | | | |
| At 1 January | 13,563 | 3,917 | - | - |
| Fair value changes on available-for-sale securities: | | | | |
| – revaluation | (944) | 9,884 | - | - |
| – realisation on disposal | (63) | (296) | - | - |
| – tax effect | (20) | 55 | - | - |
| Fair value changes on cash flow hedges: | | | | |
| – transferred to income and expenditure account | 3 | 4 | - | - |
| – tax effect | - | (1) | - | - |
| | (1,024) | 9,646 | - | - |
| At 31 December | 12,539 | 13,563 | - | - |
| Translation reserve | | | | |
| At 1 January | 73 | 36 | - | - |
| Currency translation differences: | | | | |
| – subsidiaries and joint ventures | (890) | 37 | - | - |
| – reserve released on disposal of a subsidiary classified as assets held for sale | (13) | - | - | - |
| | (903) | 37 | - | - |
| At 31 December | (830) | 73 | - | - |
| | 677,704 | 671,625 | 635,452 | 637,508 |
| Non-controlling interests | | | | |
| At 1 January | 566 | 478 | - | - |
| Surplus for the year | 127 | 72 | - | - |
| Currency translation differences | (16) | 1 | - | - |
| Capital injection by non-controlling interests | 228 | 38 | - | - |
| Disposal of a subsidiary classified as assets held for sale | (13) | - | - | - |
| Dividends paid to non-controlling interests | (14) | (23) | - | - |
| At 31 December | 878 | 566 | - | - |
| TOTAL | 678,582 | 672,191 | 635,452 | 637,508 |

Exchange Fund – Notes to the Financial Statements (continued)

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

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

| | Group | | Fund | |
|--|----------------|---------|----------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| Cash and money at call | 196,701 | 128,692 | 195,528 | 127,739 |
| Placements with banks and other financial institutions | 125,726 | 165,042 | 117,774 | 163,529 |
| Treasury bills and commercial paper | 480 | 34,760 | 480 | 34,760 |
| TOTAL | 322,907 | 328,494 | 313,782 | 326,028 |

Reconciliation with the balance sheet

| Note | Group | | Fund | |
|---|-------|------------------|-------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Amounts shown in the balance sheet | | | | |
| Cash and money at call | 7 | 196,701 | 128,692 | 195,528 |
| Placements with banks and other financial institutions | 8 | 138,239 | 176,632 | 120,080 |
| Financial assets designated at fair value | | | | |
| Treasury bills and commercial paper | 10 | 719,166 | 1,077,684 | 719,166 |
| | | 1,054,106 | 1,383,008 | 1,034,774 |
| Less: Amounts with original maturity beyond 3 months | | (731,199) | (1,054,514) | (720,992) |
| Cash and cash equivalents in the statement of cash flows | | 322,907 | 328,494 | 313,782 |
| | | | | 326,028 |

Exchange Fund – Notes to the Financial Statements (continued)

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

32 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 32(a)) | | Reserves Management | | Financial Stability and Other Activities | | Total | |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Income | | | | | | | | |
| Interest and dividend income | 3,738 | 4,664 | 24,862 | 22,918 | 1,168 | 1,080 | 29,768 | 28,662 |
| Investment gains/(losses) | 2,417 | [8,505] | 16,995 | 51,386 | (658) | 362 | 18,754 | 43,243 |
| Other income | - | - | 21 | 42 | 668 | 681 | 689 | 723 |
| | 6,155 | [3,841] | 41,878 | 74,346 | 1,178 | 2,123 | 49,211 | 72,628 |
| Expenditure | | | | | | | | |
| Interest expense | 1,389 | 1,251 | 36,603 | 46,468 | 265 | 255 | 38,257 | 47,974 |
| Other expenses | 922 | 922 | 1,363 | 1,455 | 2,183 | 2,055 | 4,468 | 4,432 |
| | 2,311 | 2,173 | 37,966 | 47,923 | 2,448 | 2,310 | 42,725 | 52,406 |
| Surplus/(Deficit) before share of profit of associates and joint ventures | | | | | | | | |
| | 3,844 | [6,014] | 3,912 | 26,423 | (1,270) | [187] | 6,486 | 20,222 |
| Share of profit of associates and joint ventures, net of tax | - | - | 1,713 | 678 | 17 | 10 | 1,730 | 688 |
| Surplus/(Deficit) before taxation | 3,844 | [6,014] | 5,625 | 27,101 | (1,253) | [177] | 8,216 | 20,910 |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Group | | | | | | | | | |
|---|---|-----------|---------------------|-----------|--|---------|-------------------------------------|---------|------------------|-----------|
| | Currency Board Operations (note 32[a]) | | Reserves Management | | Financial Stability and Other Activities | | Re-allocation (note 32[b] & [c]) | | Total | |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Assets | | | | | | | | | | |
| Backing Assets | | | | | | | | | | |
| Investment in designated US dollar assets | 1,449,637 | 1,372,916 | - | - | - | - | - | - | 1,449,637 | 1,372,916 |
| Interest receivable on designated US dollar assets | 1,309 | 1,176 | - | - | - | - | - | - | 1,309 | 1,176 |
| Net accounts receivable/(payable) | (7,750) | (25,188) | - | - | - | - | 7,750 | 25,188 | - | - |
| Other investments | - | - | 1,607,178 | 1,532,082 | 157,899 | 143,726 | (1,600) | (1,800) | 1,763,477 | 1,674,008 |
| Other assets | - | - | 21,604 | 24,172 | 5,799 | 10,995 | 875 | 33,287 | 28,278 | 68,454 |
| TOTAL ASSETS | 1,443,196 | 1,348,904 | 1,628,782 | 1,556,254 | 163,698 | 154,721 | 7,025 | 56,675 | 3,242,701 | 3,116,554 |
| Liabilities | | | | | | | | | | |
| Monetary Base | | | | | | | | | | |
| Certificates of Indebtedness | 340,184 | 327,372 | - | - | - | - | - | - | 340,184 | 327,372 |
| Government-issued currency notes and coins in circulation | 11,028 | 10,575 | - | - | - | - | - | - | 11,028 | 10,575 |
| Balance of the banking system | 239,183 | 164,093 | - | - | - | - | - | - | 239,183 | 164,093 |
| Exchange Fund Bills and Notes issued | 753,546 | 784,604 | - | - | - | - | (1,600) | (1,999) | 751,946 | 782,605 |
| Interest payable on Exchange Fund Notes | 166 | 177 | - | - | - | - | - | - | 166 | 177 |
| Net accounts (receivable)/payable | (727) | (32,968) | - | - | - | - | 875 | 33,486 | 148 | 518 |
| Other debt securities issued | - | - | - | - | 33,270 | 31,335 | - | - | 33,270 | 31,335 |
| Placements by banks and other financial institutions | - | - | 830 | - | 63,171 | 50,734 | - | - | 64,001 | 50,734 |
| Bank loans | - | - | 8,778 | 9,525 | - | - | - | - | 8,778 | 9,525 |
| Placements by Fiscal Reserves | - | - | 788,681 | 773,862 | - | - | - | - | 788,681 | 773,862 |
| Placements by HKSAR government funds and statutory bodies | - | - | 259,169 | 213,262 | 1,970 | 1,649 | - | - | 261,139 | 214,911 |
| Other liabilities | - | - | 49,723 | 40,343 | 8,122 | 13,125 | 7,750 | 25,188 | 65,595 | 78,656 |
| TOTAL LIABILITIES | 1,343,380 | 1,253,853 | 1,107,181 | 1,036,992 | 106,533 | 96,843 | 7,025 | 56,675 | 2,564,119 | 2,444,363 |

Exchange Fund – Notes to the Financial Statements (continued)

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

(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 are 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 107.27% as at 31 December 2014 (2013: 107.41%).

(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 2014, deductions from the Backing Assets comprised "Other liabilities" of HK\$7,750 million (2013: HK\$25,188 million).

The Monetary Base is also presented on a net basis. As at 31 December 2014, deductions from the Monetary Base comprising "other assets" of HK\$875 million (2013: HK\$33,486 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\$27 million (2013: HK\$21 million) and unrealised gains of HK\$848 million (2013: HK\$516 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 are included in "net accounts (receivable)/payable" to reduce the Monetary Base. There were no such advances at 31 December 2014 (2013: HK\$199 million).
- EFBN issued on tender date but not yet settled are included in "net accounts (receivable)/payable" to reduce the Monetary Base. There was no such receivable at 31 December 2014 (2013: HK\$32,750 million).

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

Exchange Fund – Notes to the Financial Statements (continued)

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

33 PLEDGED ASSETS

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

| Note | Group | | Fund | |
|--|-------|---------------|--------|--------------|
| | 2014 | 2013 | 2014 | 2013 |
| Secured liabilities | | | | |
| Equity index futures contracts, at fair value | 12(a) | – | 132 | – |
| Bond futures contracts, at fair value | 12(a) | 8 | – | 8 |
| Interest rate futures contracts, at fair value | 12(a) | 1 | – | 1 |
| Interest rate swap, at fair value | | 27 | 4 | 27 |
| Bank loans | 27 | 8,778 | 9,525 | – |
| Assets pledged | | | | |
| Cash and money at call | | 92 | 2 | 92 |
| Financial assets designated at fair value | | 6,901 | 6,327 | 6,901 |
| Investment properties | | 17,493 | 17,695 | – |

During the year, the Group entered into collateralised reverse repurchase agreements, repurchase agreements and securities lending transactions that may result in credit exposure in the event that the counterparty to the transaction is unable to fulfil its contractual obligations. The Group controls credit risk associated with these activities by monitoring counterparty credit exposure and collateral values on a daily basis and requiring additional collateral to be deposited with or returned to the Group when deemed necessary.

These transactions are conducted under terms that are usual and customary to standard lending, and securities borrowing and lending activities.

Exchange Fund – Notes to the Financial Statements (continued)

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

34 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 | |
|---------------------------------------|-------|------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Contracted for | 6 | 14 | 6 | 9 |
| Authorised but not yet contracted for | 227 | 275 | 181 | 253 |
| | 233 | 289 | 187 | 262 |

(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 2014, the Fund had an undertaking under the NAB to lend foreign currencies to the IMF up to HK\$3,820 million equivalent (2013: HK\$4,060 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\$459 million equivalent with a repayment term of five years (2013: HK\$527 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 (2013: 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 2014, there was no outstanding balance due from the HKDPB under this facility (2013: 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 (2013: HK\$30 billion) at prevailing market interest rates. As at 31 December 2014, there was no outstanding balance due from the HKMC under this facility (2013: 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\$44,590 million equivalent (2013: HK\$44,584 million equivalent). The arrangement allows each organisation to enhance the liquidity of its foreign reserve portfolio with minimal additional risk. As at 31 December 2014, there was no outstanding transaction with any central bank under this arrangement (2013: Nil).

Exchange Fund – Notes to the Financial Statements (continued)

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

(f) Chiang Mai Initiative Multilateralisation Agreement

The Chiang Mai Initiative Multilateralisation (CMIM) was established under the aegis of the 10 Association of Southeast Asian Nations (ASEAN) member countries together with China, Japan and Korea (ASEAN+3) to provide short-term US dollars through currency swap transactions to participants facing balance-of-payments and liquidity difficulties with a total size of US\$240 billion (2013: US\$120 billion). Hong Kong, through the HKMA, participates in the CMIM and has undertaken to commit up to US\$8.4 billion (2013: US\$4.2 billion) out of the Fund. Hong Kong has the right to request liquidity support up to US\$6.3 billion (2013: US\$2.1 billion) from the CMIM in case of emergency. Up to 31 December 2014, there had been no request to activate the CMIM (2013: Nil).

(g) Bilateral swap agreement

The People's Bank of China and the HKMA renewed a bilateral swap agreement in November 2014 for another three years, with a size of RMB400 billion/HK\$505 billion. This currency swap agreement helps facilitate the development of offshore renminbi business in Hong Kong. The bilateral swap outstanding as at 31 December 2014 was RMB51.1 billion (2013: RMB40 billion).

(h) Investment commitments

The Group's subsidiaries with principal activities of holding investments, including properties, had outstanding investment commitment of HK\$80,948 million equivalent as at 31 December 2014 (2013: HK\$80,211 million equivalent).

(i) Lease commitments

As at 31 December 2014, the total future minimum lease payments payable under non-cancellable operating leases of premises were as follows:

| | Group | | Fund | |
|--|------------|------|------------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Within one year | 92 | 90 | 61 | 59 |
| After one year but not later than five years | 175 | 211 | 113 | 158 |
| Later than five years | 4 | 16 | 4 | 16 |
| TOTAL | 271 | 317 | 178 | 233 |

(j) Financial Dispute Resolution Centre Limited

The HKMA signed a Memorandum of Understanding together with the Financial Services and the Treasury Bureau and the Securities and Futures Commission on 21 December 2011 regarding the funding arrangement on the set-up and operating costs of the Financial Dispute Resolution Centre Limited (FDRCL). The funding arrangement has been extended for three years to December 2017. During the year, the Fund contributed HK\$4 million to FDRCL (2013: HK\$4 million). The outstanding commitment of the Fund to contribute to FDRCL as at 31 December 2014 was HK\$21 million (2013: HK\$14 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

35 CONTINGENT LIABILITIES

As at 31 December 2014, the Fund had a contingent liability of up to 16.1 million Special Drawing Rights or HK\$181 million equivalent (2013: 16.1 million Special Drawing Rights or HK\$192 million equivalent), in respect of the uncalled portion of its 4,285 shares (2013: 4,285 shares) in the Bank for International Settlements (note 11).

36 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\$108 million (2013: HK\$151 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.

37 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.

37.1 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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 and Compliance Department (RC Department), which is independent of the Reserves Management Department, carries out the risk management activities of the Fund.

37.2 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:

| | 2014 | 2013 |
|----------------------------------|-------------|------|
| Asset type | | |
| Bonds | 73% | 74% |
| Equities and related investments | 27% | 26% |
| | 100% | 100% |
| Currency | | |
| US dollar and Hong Kong dollar | 77% | 77% |
| Others ¹ | 23% | 23% |
| | 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 RC Department is responsible for risk management and compliance monitoring regarding the investments of the Fund. The RC Department monitors the risk exposure of the Fund, checks compliance of investment activities against established guidelines and reports and follows up any identified breaches.

Exchange Fund – Notes to the Financial Statements (continued)

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

37.3 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.

37.3.1 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 RC Department 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

(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 RC Department 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.

37.3.2 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:

| | Note | Group | | Fund | |
|---|------|----------------|---------|----------------|---------|
| | | 2014 | 2013 | 2014 | 2013 |
| Risk in force – mortgage insurance | 37.6 | 13,118 | 14,454 | – | – |
| Risk in force – other guarantees and insurance | 37.6 | 2,094 | 1,625 | – | – |
| Loan commitments, guarantees and other credit related commitments | | 314,061 | 280,908 | 263,113 | 230,697 |
| TOTAL | | 329,273 | 296,987 | 263,113 | 230,697 |

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

Exchange Fund – Notes to the Financial Statements (continued)

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

37.3.3 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 2014, approximately 85% (2013: 91%) 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 | |
|---|------------------|------------------|------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Cash and money at call, placements with banks and other financial institutions, by credit rating¹ | | | | |
| AAA | 14 | 273 | 14 | 273 |
| AA- to AA + | 86,141 | 104,560 | 79,398 | 100,677 |
| A- to A + | 131,487 | 144,704 | 120,007 | 137,188 |
| Lower than A- or un-rated ² | 117,298 | 55,787 | 116,189 | 54,681 |
| | 334,940 | 305,324 | 315,608 | 292,819 |
| Debt securities, by credit rating¹ | | | | |
| AAA | 355,016 | 401,188 | 353,811 | 398,614 |
| AA- to AA + | 1,500,054 | 1,513,665 | 1,490,654 | 1,506,633 |
| A- to A + | 91,036 | 50,106 | 88,223 | 48,146 |
| Lower than A- or un-rated ² | 224,197 | 137,872 | 213,572 | 126,631 |
| | 2,170,303 | 2,102,831 | 2,146,260 | 2,080,024 |
| Loan portfolio | | | | |
| Neither past due nor impaired [note 37.3.3(a)] | 15,212 | 21,969 | – | – |
| Past due but not impaired [note 37.3.3(b)] | 359 | 299 | – | – |
| Impaired [note 37.3.3(c)] | 2 | 2 | – | – |
| Allowance for loan impairment | (1) | [2] | – | – |
| | 15,572 | 22,268 | – | – |
| TOTAL | 2,520,815 | 2,430,423 | 2,461,868 | 2,372,843 |

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

(a) Loans that are neither past due nor impaired

An internal rating system is used for assessing the credit quality of the loan portfolio. Grades 1 to 3 include loans with no previous past due experience and with different levels of credit enhancements in addition to the collateral. Grade 4 includes loans with previous past due experience and with 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 | |
|--------------|---------------|--------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Grades | | | | |
| 1 to 3 | 15,191 | 21,950 | – | – |
| 4 | – | – | – | – |
| 5 | 21 | 19 | – | – |
| TOTAL | 15,212 | 21,969 | – | – |

(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 | |
|--|--------------|-------|------|------|
| | 2014 | 2013 | 2014 | 2013 |
| Loans that were past due | | | | |
| 90 days or less | 358 | 297 | – | – |
| 91 to 180 days | – | – | – | – |
| over 180 days | 1 | 2 | – | – |
| TOTAL | 359 | 299 | – | – |
| Fair value of collateral and other credit enhancements | 2,584 | 2,156 | – | – |

Exchange Fund – Notes to the Financial Statements (continued)

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

(c) Impaired loans

These are loans where the Group determines on an individual basis that it is probable that it will be unable to collect all principal and interest due according to the contractual terms of the loan agreements. As at 31 December 2014, the fair value of related collateral held and credit enhancement was HK\$5 million (2013: HK\$4 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 2014, repossessed properties of the Group amounted to HK\$1 million (2013: HK\$2 million).

37.3.4 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 | |
|---|------------------|-----------|------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Governments and government agencies ¹ | 1,977,746 | 1,882,464 | 1,977,462 | 1,881,476 |
| Supra-nationals | 159,847 | 143,575 | 159,847 | 143,564 |
| States, provinces and public-sector entities ² | 166,689 | 188,729 | 196,008 | 217,964 |
| Financial institutions | 275,277 | 282,407 | 246,950 | 262,969 |
| Others ³ | 296,647 | 304,954 | 252,188 | 227,666 |
| TOTAL | 2,876,206 | 2,802,129 | 2,832,455 | 2,733,639 |

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

37.4 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.

37.4.1 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

37.4.2 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 RC Department 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.

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

37.4.3 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 - 2014 | | | | | | | Non-interest-bearing financial instruments | |
|--|--|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|----------------|------------------|--|--|
| | Repricing period of interest-bearing financial instruments | | | | | | | | |
| | 1 month or less | 3 months or less but over 1 month | 1 year or less but over 3 months | 5 years or less but over 1 year | 10 years or less but over 5 years | Over 10 years | Total | | |
| Assets | | | | | | | | | |
| Cash and money at call | 132,002 | - | - | - | - | - | 132,002 | 64,699 | |
| Placements with banks and other financial institutions | 128,422 | 8,054 | 1,744 | - | - | - | 138,220 | 19 | |
| Financial assets designated at fair value | 356,282 | 297,577 | 678,489 | 510,146 | 193,976 | 101,935 | 2,138,405 | 592,810 | |
| Available-for-sale securities | 849 | 1,134 | 1,073 | 1,194 | - | - | 4,250 | 83,406 | |
| Held-to-maturity securities | 12 | 250 | 929 | 4,388 | 3,590 | - | 9,169 | - | |
| Loan portfolio | 14,465 | 1,051 | 20 | 34 | 2 | - | 15,572 | - | |
| Interest-bearing assets | 632,032 | 308,066 | 682,255 | 515,762 | 197,568 | 101,935 | 2,437,618 | | |
| Liabilities | | | | | | | | | |
| Placements by banks and other financial institutions | 830 | - | - | - | - | - | 830 | 63,171 | |
| Placements by Fiscal Reserves with interest payable at market-based rates ¹ | 3 | - | - | - | - | - | 3 | - | |
| Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹ | 1,970 | - | - | - | - | - | 1,970 | - | |
| Exchange Fund Bills and Notes issued | 167,583 | 323,692 | 206,049 | 37,204 | 11,274 | 6,144 | 751,946 | - | |
| Bank loans | 8,778 | - | - | - | - | - | 8,778 | - | |
| Other debt securities issued | 8,168 | 10,010 | 4,002 | 8,040 | 3,050 | - | 33,270 | - | |
| Interest-bearing liabilities | 187,332 | 333,702 | 210,051 | 45,244 | 14,324 | 6,144 | 796,797 | | |
| Net interest-bearing assets/(liabilities) | 444,700 | (25,636) | 472,204 | 470,518 | 183,244 | 95,791 | 1,640,821 | | |
| Interest rate derivatives (net position, notional amounts) | 44,030 | (49,894) | (15,411) | 1,372 | 12,290 | 6,000 | (1,613) | | |
| Interest rate sensitivity gap | 488,730 | (75,530) | 456,793 | 471,890 | 195,534 | 101,791 | 1,639,208 | | |

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 2014, such placements amounted to HK\$1,047,847 million (2013: HK\$987,077 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Repricing period of interest-bearing financial instruments | | | | | | | Non-interest-bearing financial instruments |
|--|--|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|---------------|------------------|--|
| | 1 month or less | 3 months or less but over 1 month | 1 year or less but over 3 months | 5 years or less but over 1 year | 10 years or less but over 5 years | Over 10 years | Total | |
| Assets | | | | | | | | |
| Cash and money at call | 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 2014, such placements amounted to HK\$1,047,847 million (2013: HK\$987,077 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Fund - 2014 | | | | | | | | Non-interest-bearing financial instruments |
|--|--|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|----------------|------------------|---------|--|
| | Repricing period of interest-bearing financial instruments | | | | | | | | |
| | 1 month or less | 3 months or less but over 1 month | 1 year or less but over 3 months | 5 years or less but over 1 year | 10 years or less but over 5 years | Over 10 years | Total | | |
| Assets | | | | | | | | | |
| Cash and money at call | 131,534 | - | - | - | - | - | 131,534 | 63,994 | |
| Placements with banks and other financial institutions | 119,305 | 775 | - | - | - | - | 120,080 | - | |
| Financial assets designated at fair value | 356,253 | 297,526 | 678,440 | 510,113 | 193,952 | 101,935 | 2,138,219 | 581,154 | |
| Interest-bearing assets | 607,092 | 298,301 | 678,440 | 510,113 | 193,952 | 101,935 | 2,389,833 | | |
| Liabilities | | | | | | | | | |
| Placements by banks and other financial institutions | 830 | - | - | - | - | - | 830 | 63,171 | |
| Placements by Fiscal Reserves with interest payable at market-based rates ¹ | 3 | - | - | - | - | - | 3 | - | |
| Placements by HKSAR government funds and statutory bodies with interest payable at market-based rates ¹ | 1,970 | - | - | - | - | - | 1,970 | - | |
| Exchange Fund Bills and Notes issued | 168,083 | 323,692 | 206,049 | 37,204 | 11,274 | 6,144 | 752,446 | - | |
| Interest-bearing liabilities | 170,886 | 323,692 | 206,049 | 37,204 | 11,274 | 6,144 | 755,249 | | |
| Net interest-bearing assets/(liabilities) | 436,206 | (25,391) | 472,391 | 472,909 | 182,678 | 95,791 | 1,634,584 | | |
| Interest rate derivatives (net position, notional amounts) | 39,162 | (37,775) | (19,387) | 2,400 | 9,600 | 6,000 | - | | |
| Interest rate sensitivity gap | 475,368 | (63,166) | 453,004 | 475,309 | 192,278 | 101,791 | 1,634,584 | | |

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 2014, such placements amounted to HK\$1,047,847 million (2013: HK\$987,077 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Fund – 2013 Repricing period of interest-bearing financial instruments | | | | | | | Non-interest-bearing financial instruments |
|--|---|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|---------------|------------------|--|
| | 1 month or less | 3 months or less but over 1 month | 1 year or less but over 3 months | 5 years or less but over 1 year | 10 years or less but over 5 years | Over 10 years | Total | |
| Assets | | | | | | | | |
| Cash and money at call | 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 2014, such placements amounted to HK\$1,047,847 million (2013: HK\$987,077 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

(b) Currency risk

The currency exposure of the Group is summarised below:

| | Group | | | |
|---------------------|-----------------------------|----------------------------------|-----------------------------|----------------------------------|
| | 2014 | | 2013 | |
| | Assets (in HK\$ billion) | Liabilities (in HK\$ billion) | Assets (in HK\$ billion) | Liabilities (in HK\$ billion) |
| Hong Kong dollar | 263.6 | 2,157.1 | 311.0 | 2,013.3 |
| US dollar | 2,405.7 | 382.1 | 2,281.8 | 408.8 |
| | 2,669.3 | 2,539.2 | 2,592.8 | 2,422.1 |
| Others ¹ | 573.4 | 24.9 | 523.8 | 22.3 |
| TOTAL | 3,242.7 | 2,564.1 | 3,116.6 | 2,444.4 |

| | Fund | | | |
|---------------------|-----------------------------|----------------------------------|-----------------------------|----------------------------------|
| | 2014 | | 2013 | |
| | Assets (in HK\$ billion) | Liabilities (in HK\$ billion) | Assets (in HK\$ billion) | Liabilities (in HK\$ billion) |
| Hong Kong dollar | 228.9 | 2,133.7 | 278.6 | 1,992.1 |
| US dollar | 2,367.2 | 377.5 | 2,250.0 | 400.1 |
| | 2,596.1 | 2,511.2 | 2,528.6 | 2,392.2 |
| Others ¹ | 552.9 | 2.3 | 504.2 | 3.1 |
| TOTAL | 3,149.0 | 2,513.5 | 3,032.8 | 2,395.3 |

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

(c) Equity price risk

As at 31 December 2014 and 2013, the majority of equity investments were reported as "financial assets designated at fair value" as shown in note 10.

Exchange Fund – Notes to the Financial Statements (continued)

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

37.4.4 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 | |
|-----------------------------|---------------|--------|
| | 2014 | 2013 |
| Value-at-Risk | | |
| At 31 December ¹ | 25,231 | 26,736 |
| During the year | | |
| Average | 22,488 | 29,431 |
| Maximum | 27,265 | 47,008 |
| Minimum | 16,674 | 20,523 |

¹ The amount represented 0.8% of the Fund's investments which were subject to VaR measurement as at 31 December 2014 (2013: 0.9%).

37.5 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.

37.5.1 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 RC Department and any breaches are reported to the ISC and the EFAC and are promptly followed up.

Exchange Fund – Notes to the Financial Statements (continued)

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

37.5.2 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 – 2014 | | | | | | | Total |
|---|------------------|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|---------------|------------------|---------|
| | 1 month or less | 3 months or less but over 1 month | 1 year or less but over 3 months | 5 years or less but over 1 year | 10 years or less but over 5 years | Over 10 years | | |
| Non-derivative cash outflows | | | | | | | | |
| Certificates of Indebtedness | 340,184 | - | - | - | - | - | - | 340,184 |
| Government-issued currency notes and coins in circulation | 11,028 | - | - | - | - | - | - | 11,028 |
| Balance of the banking system | 239,183 | - | - | - | - | - | - | 239,183 |
| Placements by banks and other financial institutions | 830 | - | 63,171 | - | - | - | - | 64,001 |
| Placements by Fiscal Reserves | 788,681 | - | - | - | - | - | - | 788,681 |
| Placements by HKSAR government funds and statutory bodies | 131,349 | 15,000 | 20,000 | 67,650 | 27,140 | - | - | 261,139 |
| Exchange Fund Bills and Notes issued | 167,581 | 323,895 | 206,734 | 39,100 | 12,342 | 6,340 | - | 755,992 |
| Bank loans | 99 | - | 294 | 9,669 | - | - | - | 10,062 |
| Other debt securities issued | 2,331 | 3,307 | 10,913 | 14,975 | 3,114 | - | - | 34,640 |
| Other liabilities | 58,500 | 377 | 86 | - | 257 | - | - | 59,220 |
| Loan commitments and other credit related commitments | 314,061 | - | - | - | - | - | - | 314,061 |
| TOTAL | 2,053,827 | 342,579 | 301,198 | 131,394 | 42,853 | 6,340 | 2,878,191 | |
| Derivative cash (inflows)/outflows | | | | | | | | |
| Derivative financial instruments settled: | | | | | | | | |
| – on net basis | 305 | 98 | 895 | 81 | 162 | 49 | 1,590 | |
| – on gross basis | | | | | | | | |
| Total outflows | 25,498 | 38,236 | 7,391 | 6,706 | 873 | - | 78,704 | |
| Total inflows | (24,311) | (37,114) | (7,303) | (5,722) | (878) | - | (75,328) | |
| TOTAL | 1,492 | 1,220 | 983 | 1,065 | 157 | 49 | 4,966 | |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Group – 2013 | | | | | | | Total |
|---|------------------|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|---------------|------------------|---------|
| | 1 month or less | 3 months or less but over 1 month | 1 year or less but over 3 months | 5 years or less but over 1 year | 10 years or less but over 5 years | Over 10 years | | |
| Non-derivative cash outflows | | | | | | | | |
| Certificates of Indebtedness | 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 | |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Fund – 2014 | | | | | | | Total | |
|---|--------------------|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|---------------|---|------------------|--|
| | Remaining maturity | | | | | | | | |
| | 1 month or less | 3 months or less but over 1 month | 1 year or less but over 3 months | 5 years or less but over 1 year | 10 years or less but over 5 years | Over 10 years | | | |
| Non-derivative cash outflows | | | | | | | | | |
| Certificates of Indebtedness | 340,184 | - | - | - | - | - | - | 340,184 | |
| Government-issued currency notes and coins in circulation | 11,028 | - | - | - | - | - | - | 11,028 | |
| Balance of the banking system | 239,183 | - | - | - | - | - | - | 239,183 | |
| Placements by banks and other financial institutions | 830 | - | 63,171 | - | - | - | - | 64,001 | |
| Placements by Fiscal Reserves | 788,681 | - | - | - | - | - | - | 788,681 | |
| Placements by HKSAR government funds and statutory bodies | 131,349 | 15,000 | 20,000 | 67,650 | 27,140 | - | - | 261,139 | |
| Exchange Fund Bills and Notes issued | 168,081 | 323,895 | 206,734 | 39,100 | 12,342 | 6,340 | - | 756,492 | |
| Other liabilities | 52,570 | 377 | 86 | - | - | - | - | 53,033 | |
| Loan commitments and other credit related commitments | 263,113 | - | - | - | - | - | - | 263,113 | |
| TOTAL | 1,995,019 | 339,272 | 289,991 | 106,750 | 39,482 | 6,340 | - | 2,776,854 | |
| Derivative cash (inflows)/outflows | | | | | | | | | |
| Derivative financial instruments settled: | | | | | | | | | |
| – on net basis | 305 | 97 | 904 | 71 | 160 | 49 | - | 1,586 | |
| – on gross basis | | | | | | | | | |
| Total outflows | 23,636 | 34,546 | 414 | - | - | - | - | 58,596 | |
| Total inflows | (22,531) | (33,591) | (406) | - | - | - | - | (56,528) | |
| TOTAL | 1,410 | 1,052 | 912 | 71 | 160 | 49 | - | 3,654 | |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Fund – 2013 | | | | | | | Total |
|---|------------------|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|---------------|--------------------|------------------|
| | 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 | Remaining maturity | |
| 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 | |

Exchange Fund – Notes to the Financial Statements (continued)

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

37.6 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 2014, the total risk-in-force was HK\$13.1 billion (2013: HK\$14.5 billion), of which HK\$11 billion (2013: HK\$12 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 2014, the total risk-in-force was HK\$2.1 billion (2013: HK\$1.6 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

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.

37.7 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 supplemented with quarterly updates. It 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 RC Department 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.

Exchange Fund – Notes to the Financial Statements (continued)

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

38 FAIR VALUE MEASUREMENT OF FINANCIAL INSTRUMENTS

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

38.1.1 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 – 2014 | | | |
|--|--------------|---------|---------|-----------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Financial assets designated at fair value | | | | |
| Treasury bills and commercial paper | 278,753 | 440,413 | – | 719,166 |
| Certificates of deposit | – | 59,648 | – | 59,648 |
| Other debt securities | 1,327,592 | 39,910 | 10,568 | 1,378,070 |
| Equity securities | 493,768 | 53,437 | 27,126 | 574,331 |
| | 2,100,113 | 593,408 | 37,694 | 2,731,215 |
| Available-for-sale securities | | | | |
| Debt securities | 2,524 | 1,726 | – | 4,250 |
| Equity securities | 984 | – | – | 984 |
| Investment funds | – | – | 81,929 | 81,929 |
| | 3,508 | 1,726 | 81,929 | 87,163 |
| Derivative financial instruments | 961 | 6,466 | 127 | 7,554 |
| | 2,104,582 | 601,600 | 119,750 | 2,825,932 |
| Liabilities | | | | |
| Exchange Fund Bills and Notes issued | – | 751,946 | – | 751,946 |
| Derivative financial instruments | 305 | 5,371 | – | 5,676 |
| Other debt securities issued, designated at fair value | – | 336 | – | 336 |
| | 305 | 757,653 | – | 757,958 |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | 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 |
| Other 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 |

Exchange Fund – Notes to the Financial Statements (continued)

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

| | Fund – 2014 | | | |
|---|-------------|---------|---------|-----------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets | | | | |
| Financial assets designated at fair value | | | | |
| Treasury bills and commercial paper | 278,753 | 440,413 | – | 719,166 |
| Certificates of deposit | – | 59,648 | – | 59,648 |
| Other debt securities | 1,327,592 | 39,854 | – | 1,367,446 |
| Equity securities | 493,768 | 53,437 | 25,908 | 573,113 |
| | 2,100,113 | 593,352 | 25,908 | 2,719,373 |
| Derivative financial instruments | 961 | 5,909 | – | 6,870 |
| | 2,101,074 | 599,261 | 25,908 | 2,726,243 |
| Liabilities | | | | |
| Exchange Fund Bills and Notes issued | – | 752,446 | – | 752,446 |
| Derivative financial instruments | 305 | 3,280 | – | 3,585 |
| | 305 | 755,726 | – | 756,031 |

| | 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 |
| Other 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 |

The Group's policy is to recognise transfers between levels of fair value hierarchy as at the end of the reporting period in which they occur. During the year, there were no transfers of financial instruments between Level 1 and Level 2 of the fair value hierarchy.

Exchange Fund – Notes to the Financial Statements (continued)

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

An analysis of the movement between opening and closing balances of Level 3 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 | |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| At 1 January | 34,115 | 27,831 | 61,819 | 37,572 | 677 | 303 |
| Net gains/(losses) recognised in the income and expenditure account | 432 | 3,584 | – | 112 | (550) | 374 |
| Net gains/(losses) recognised in other comprehensive income | – | – | (1,123) | 9,922 | – | – |
| Purchases | 13,577 | 10,217 | 27,467 | 17,274 | – | – |
| Sales | (10,223) | (7,585) | (6,234) | (3,061) | – | – |
| Transfers into Level 3 | 664 | 355 | – | – | – | – |
| Transfers out of Level 3 | (871) | (287) | – | – | – | – |
| At 31 December | 37,694 | 34,115 | 81,929 | 61,819 | 127 | 677 |
| Net gains/(losses) recognised in the income and expenditure account relating to those assets held at the balance sheet date | 117 | 3,868 | – | – | (550) | 374 |

| | Fund | | | |
|--|--------------------------|---------|--------------------|------|
| | Designated at fair value | | Available-for-sale | |
| | 2014 | 2013 | 2014 | 2013 |
| At 1 January | 21,879 | 18,414 | – | – |
| Net gains recognised in the income and expenditure account | 1,264 | 2,079 | – | – |
| Purchases | 8,774 | 6,179 | – | – |
| Sales | (5,727) | (4,888) | – | – |
| Transfers into Level 3 | 589 | 332 | – | – |
| Transfers out of Level 3 | (871) | (237) | – | – |
| At 31 December | 25,908 | 21,879 | – | – |
| Net gains recognised in the income and expenditure account relating to those assets held at the balance sheet date | 953 | 2,353 | – | – |

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.

Exchange Fund – Notes to the Financial Statements (continued)

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

38.1.2 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 discounted cash flow 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 | |
|--|---------------------|-------------|
| | 2014 | 2013 |
| Earning multiples of similar companies | 7.6 – 14.5 | 10.1 – 19.3 |
| Liquidity discount | 20% | 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\$3,782 million (2013: HK\$3,479 million) and in other comprehensive income of HK\$8,193 million (2013: HK\$6,182 million).

Exchange Fund – Notes to the Financial Statements (continued)

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

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

The fair values of held-to-maturity securities and other debt securities issued that were not designated at fair value are shown below:

| | Note | Group – 2014 | | | |
|------------------------------|------|----------------|------------|--------|--------|
| | | Carrying value | Fair value | | |
| | | Level 1 | Level 2 | Total | |
| Financial assets | | | | | |
| Held-to-maturity securities | 13 | 9,169 | 7,348 | 2,096 | 9,444 |
| Financial liabilities | | | | | |
| Other debt securities issued | 28 | 32,934 | – | 32,936 | 32,936 |

| | Note | Group – 2013 | | | |
|------------------------------|------|----------------|------------|--------|--------|
| | | Carrying value | Fair value | | |
| | | Level 1 | Level 2 | Total | |
| Financial assets | | | | | |
| Held-to-maturity securities | 13 | 8,624 | 5,725 | 3,039 | 8,764 |
| Financial liabilities | | | | | |
| Other debt securities issued | 28 | 31,010 | – | 31,011 | 31,011 |

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 2014 and 2013.

Exchange Fund – Notes to the Financial Statements (continued)

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

39 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2014

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 2014 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, except the following, which may have an impact on the classification and measurement of the Group's financial instruments:

| Effective for accounting periods beginning on or after | |
|--|----------------|
| HKFRS 9, Financial Instruments | 1 January 2018 |

HKFRS 9, Financial Instruments

HKFRS 9 addresses the classification, measurement and recognition of financial assets and financial liabilities. It replaces the guidance in HKAS 39 that relates to the classification and measurement of financial instruments. HKFRS 9 retains but simplifies the mixed measurement model and establishes three primary measurement categories for financial assets: amortised cost, fair value through other comprehensive income and fair value through profit or loss. The basis of classification depends on the entity's business model and contractual cash flow characteristics of the financial assets. Investment in equity instruments are required to be measured at fair value through profit or loss with the irrevocable option at inception to present changes in fair value in other comprehensive income. Any such changes in fair value cannot subsequently be transferred to profit or loss.

HKFRS 9 also introduces a new expected credit loss model that replaces the incurred loss impairment model used in HKAS 39. For financial liabilities there are no changes to classification and measurement except that, in respect of liabilities designated at fair value through profit or loss, any changes in fair value due to a change in own credit risk should be recognised in other comprehensive income. In addition, the hedge accounting framework has been refined, creating a stronger link between it and risk management practices and permitting the application of hedge accounting to a greater variety of hedging instruments and risks.

40 APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Financial Secretary on the advice of the Exchange Fund Advisory Committee on 8 April 2015.

Calendar of Events 2014

- 7 January** The Financial Services and the Treasury Bureau (FSTB) in conjunction with the HKMA, the Securities and Futures Commission (SFC) and the Insurance Authority jointly launch the 3-month first stage of public consultation on establishing a cross-sectoral resolution regime for financial institutions in Hong Kong.
- 14 April** The HKMA and Bank Negara Malaysia (Central Bank of Malaysia) jointly organise an Islamic finance conference in Hong Kong.
- 22 May** The Second Hong Kong-Australia Renminbi Trade and Investment Dialogue is held in Hong Kong.
- 23 May** The International Monetary Fund (IMF) affirms the resilience of financial systems and sound financial policies of Hong Kong as a major global financial centre in its Financial System Stability Assessment report under the Financial Sector Assessment Program (FSAP).
- 5–6 June** The HKMA holds anti-money laundering seminars to assist authorized institutions (AIs) to understand their money laundering and terrorist financing risks and apply a risk based approach.
- 12 June** The HKMA and the Mandatory Provident Fund Schemes Authority launch the E-Payment for the Mandatory Provident Fund Transfer system.
- 14 June** The HKMA conducts a drill with 55 banks on business continuity plans.
- 20 June** The HKMA co-chairs a workshop jointly organised by the Committee on the Global Financial System supported by the Bank for International Settlements and Financial Stability Board Standing Committee on Assessment of Vulnerabilities on “Risks from currency mismatches and leverage on corporate balance sheets” in Hong Kong.
- 24 June** The Enhanced Competency Framework for private wealth management practitioners is launched.
- 17 July** The HKMA signs a Memorandum of Understanding on Supervisory Co-operation and Exchange of Supervisory Information with the Reserve Bank of India.
- 18 July** The HKMA and the SFC launch a one-month consultation on mandatory reporting and related record keeping obligations under the new over-the-counter (OTC) derivatives transaction regime.
- 28 July** The HKMA and Bank of Thailand jointly launch the new cross-border payment-versus-payment link between Hong Kong’s US Dollar RTGS system and Thailand’s Thai baht RTGS system.
- 11 & 19 September** The HKMA together with the FSTB hold annual anti-money laundering seminars to AIs on recent regulatory development.
- 12 September** The FSTB and the HKMA jointly launch a public consultation on the proposed enhancements to the Deposit Protection Scheme to expedite payout of deposit compensation.
- 18 September** Inaugural issuance of US\$1 billion 5-year sukuk (Islamic bond) under the Government Bond Programme.

- 19 September** The Coin Collection Programme is launched to facilitate members of the public to get value for their coins in addition to the existing banking system.
- 29 September** The HKMA launches the second phase of the trade repository for OTC derivatives to support the remaining most commonly traded interest rate and foreign exchange derivatives products, and introduce equity derivative products, which enables Hong Kong to keep pace with major overseas market reforms in the OTC derivatives market.
- 13–14 October** The first Hong Kong-Thailand Renminbi Business Forum is held in Bangkok.
- 24 October** The Banking (Capital) (Amendment) Rules 2014 and the Banking (Liquidity) Rules are gazetted to implement the second phase of Basel III requirements.
- 28 October** The HKMA and Banque de France sign a Memorandum of Understanding to strengthen co-operation on renminbi business development.
The HKMA, Paris EUROPLACE and the Hong Kong Trade Development Council jointly organise a seminar on “Renminbi Internationalisation: A New Era” in Paris.
- 31 October** Consultation conclusions in connection with the proposed regulatory framework for stored value facilities and retail payment systems in Hong Kong are released.
- 1 November** The HKMA is admitted as a member of The South-East Asian Central Banks (SEACEN) group.
- 3 November** The HKMA designates seven banks as Primary Liquidity Providers for offshore renminbi market in Hong Kong.
- 10 November** The HKMA introduces a renminbi intraday liquidity facility of up to RMB10 billion to banks participating in renminbi business in Hong Kong.
- 12 November** The fourth meeting of the Hong Kong-London Renminbi Forum is held in London.
- 17 November** Launch of the Shanghai-Hong Kong Stock Connect.
Als begin conducting renminbi conversions with Hong Kong residents without applying limits.
- 28 November** The HKMA introduces several refinements to the Stable Funding Requirement to be effective from January 2015 with a view to streamline its operation and alleviate reporting burden of banks.
Consultation conclusions on the mandatory reporting and related record keeping obligations under the new OTC derivatives transactions regime are published.
- 8 December** The HKMA announces streamlining of tenors of bonds issued under the Exchange Fund Bills and Notes Programme and the Hong Kong Government Bond Programme, and the introduction of discount facility for Hong Kong Government Bonds.
- 24 December** The Banking (Disclosure) (Amendment) Rules 2014 are gazetted to introduce disclosure requirements associated with the second phase of Basel III implementation.

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Annex Authorized Institutions and Local Representative Offices

at 31 December 2014

LICENSED BANKS

Incorporated in Hong Kong

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

Incorporated outside Hong Kong

| | | |
|--|---|---|
| ABN AMRO Bank N.V. | Bank of Nova Scotia (The) | CATHAY BANK |
| AGRICULTURAL BANK OF CHINA LIMITED | BANK OF SINGAPORE LIMITED | CATHAY UNITED BANK COMPANY, LIMITED |
| Allahabad Bank | BANK OF TAIWAN | Chang Hwa Commercial Bank Ltd. |
| Australia and New Zealand Banking Group Limited | Bank of Tokyo-Mitsubishi UFJ, Ltd. (The) | Chiba Bank, Ltd. (The) |
| Axis Bank Limited | BANK SINOPAC | China Construction Bank Corporation |
| Banca Monte dei Paschi di Siena S.p.A. | Barclays Bank PLC | CHINA DEVELOPMENT BANK CORPORATION |
| Banco Bilbao Vizcaya Argentaria S.A. | BDO UNIBANK, INC. | China Everbright Bank Co., Ltd |
| BANCO SANTANDER, S.A. | also known as: BDO BDO Unibank | China Merchants Bank Co., Ltd. |
| Bangkok Bank Public Company Limited | Banco De Oro | CHINA MINSHENG BANKING CORP., LTD. |
| Bank J. Safra Sarasin AG also known as: Banque J. Safra Sarasin SA Banca J. Safra Sarasin SA Bank J. Safra Sarasin Ltd | Banco De Oro Unibank BDO Banco De Oro (formerly known as BANCO DE ORO UNIBANK, INC.) | Chugoku Bank, Ltd. (The) |
| Bank Julius Baer & Co. Ltd. | BNP PARIBAS | CIMB Bank Berhad |
| Bank of America, National Association | BNP PARIBAS SECURITIES SERVICES | Citibank, N.A. |
| Bank of Baroda | BNP PARIBAS WEALTH MANAGEMENT | Commerzbank AG |
| Bank of China Limited | BSI LTD also known as: BSI AG BSI SA | Commonwealth Bank of Australia |
| Bank of Communications Co., Ltd. | Canadian Imperial Bank of Commerce | Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. |
| Bank of India | CANARA BANK | Coutts & Co AG also known as: Coutts & Co SA Coutts & Co Ltd |
| Bank of Montreal | | |
| BANK OF NEW YORK MELLON (THE) | | |

Annex Authorized Institutions and Local Representative Offices

at 31 December 2014 (continued)

| | | |
|--|---|---|
| CREDIT AGRICOLE CORPORATE AND INVESTMENT BANK | Industrial Bank Co., Ltd. # | Royal Bank of Canada |
| Crédit Agricole (Suisse) SA | Industrial Bank of Korea | Royal Bank of Scotland N.V. (The) |
| Credit Suisse AG | Industrial Bank of Taiwan Co., Ltd. | Royal Bank of Scotland public limited company (The) |
| CTBC Bank Co., Ltd | ING Bank N.V. | Shanghai Commercial & Savings Bank, Ltd. (The) |
| DBS BANK LTD. | INTESA SANPAOLO SPA | Shanghai Pudong Development Bank Co., Ltd. |
| Deutsche Bank Aktiengesellschaft | Iyo Bank, Ltd. (The) | Shiga Bank, Ltd. (The) |
| DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main | JPMorgan Chase Bank, National Association | Shinhan Bank |
| E.Sun Commercial Bank, Ltd. | KBC Bank N.V. | Shizuoka Bank, Ltd. (The) |
| EAST WEST BANK | Korea Exchange Bank | Skandinaviska Enskilda Banken AB |
| Edmond de Rothschild (Suisse) S.A. (formerly known as Banque Privée Edmond de Rothschild SA) | Land Bank of Taiwan Co., Ltd. | Societe Generale |
| EFG Bank AG also known as: EFG Bank SA EFG Bank Ltd | LGT Bank AG also known as: LGT Bank Ltd. LGT Bank SA | SOCIETE GENERALE BANK & TRUST |
| ERSTE GROUP BANK AG | LLOYDS BANK PLC | STANDARD BANK PLC |
| Falcon Private Bank AG also known as: Falcon Private Bank Ltd. Falcon Private Bank SA | MACQUARIE BANK LIMITED | Standard Chartered Bank |
| FAR EASTERN INTERNATIONAL BANK | Malayan Banking Berhad | State Bank of India |
| First Commercial Bank, Ltd. | Mashreq Bank – Public Shareholding Company # also known as Mashreqbank psc | State Street Bank and Trust Company |
| Hachijuni Bank, Ltd. (The) | MEGA INTERNATIONAL COMMERCIAL BANK CO., LTD. | Sumitomo Mitsui Banking Corporation |
| HANA BANK | MELLIBANK PLC | Sumitomo Mitsui Trust Bank, Limited |
| HDFC BANK LIMITED | Mitsubishi UFJ Trust and Banking Corporation | Svenska Handelsbanken AB (publ) |
| HONG LEONG BANK BERHAD | Mizuho Bank, Ltd. | Ta Chong Bank, Ltd. # |
| HSBC BANK INTERNATIONAL LIMITED | National Australia Bank, Limited | TAIPEI FUBON COMMERCIAL BANK CO., LTD. |
| HSBC Bank plc | NATIONAL BANK OF ABU DHABI | TAISHIN INTERNATIONAL BANK CO., LTD |
| HSBC Bank USA, National Association | National Bank of Pakistan | Taiwan Business Bank |
| HSBC Private Bank (Suisse) SA | NATIXIS | Taiwan Cooperative Bank, Ltd. |
| Hua Nan Commercial Bank, Ltd. | NEWEDGE GROUP | Taiwan Shin Kong Commercial Bank Co., Ltd. |
| ICICI BANK LIMITED | Oversea-Chinese Banking Corporation Limited | Toronto-Dominion Bank |
| Indian Overseas Bank | Philippine National Bank | UBS AG |
| Industrial and Commercial Bank of China Limited | Pictet & Cie (Europe) S.A. | UCO Bank |
| | Portigon AG | UniCredit Bank AG |
| | PT. Bank Negara Indonesia (Persero) Tbk. | Union Bank of India |
| | Punjab National Bank | United Overseas Bank Ltd. |
| | Raiffeisen Bank International AG | Wells Fargo Bank, National Association |
| | | Westpac Banking Corporation |
| | | Woori Bank |

Addition in 2014

Annex Authorized Institutions and Local Representative Offices

at 31 December 2014 (*continued*)

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
Citicorp International Limited
J.P. MORGAN SECURITIES (ASIA
PACIFIC) LIMITED

KDB Asia Limited
KOOKMIN BANK HONG KONG
LIMITED
Morgan Stanley Asia International
Limited #
(formerly known as
Morgan Stanley Asia Private
Wealth Management 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

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
KASIKORN BANK PUBLIC
COMPANY LIMITED

Upgraded to a Licensed Bank

Mashreq Bank – Public Shareholding
Company
also known as
Mashreqbank psc

Addition in 2014

Annex Authorized Institutions and Local Representative Offices

at 31 December 2014 (*continued*)

DEPOSIT-TAKING COMPANIES

Incorporated in Hong Kong

| | | |
|--|---|---|
| BCOM Finance (Hong Kong) Limited | Henderson International Finance Limited | OCTOPUS CARDS LIMITED |
| BPI International Finance Limited | HKCB Finance Limited | PrimeCredit Limited |
| Chau's Brothers Finance Company Limited | Hung Kai Finance Company Limited | PUBLIC FINANCE LIMITED |
| Chong Hing Finance Limited | KEB Asia Finance Limited | SHINHAN ASIA LIMITED |
| Commonwealth Finance Corporation Limited | KEXIM ASIA LIMITED | Vietnam Finance Company Limited |
| Corporate Finance (D.T.C.) Limited | OCBC Inchroy Credit Corporation Limited (formerly known as Inchroy Credit Corporation Limited) | WOORI GLOBAL MARKETS ASIA LIMITED |
| FUBON CREDIT (HONG KONG) LIMITED | OCBC Wing Hang Finance Company Limited (formerly known as Wing Hang Finance Company Limited) | Deletion in 2014 |
| Gunma Finance (Hong Kong) Limited | | Sumitomo Mitsui Trust (Hong Kong) Limited |
| Habib Finance International Limited | | |
| HBZ Finance Limited | | |

Incorporated outside Hong Kong

NIL

Annex Authorized Institutions and Local Representative Offices

at 31 December 2014 (continued)

LOCAL REPRESENTATIVE OFFICES

| | | |
|--|--|--|
| ANTWERPSE DIAMANTBANK NV also known as ANTWERP DIAMOND BANK NV | CHINA GUANGFA BANK CO., LTD. CLEARSTREAM BANKING S.A. | Schroder & Co Bank AG also known as: Schroder & Co Banque SA Schroder & Co Banca SA Schroder & Co Bank Ltd Schroder & Co Banco SA |
| AS Expobank # | Corporation Bank | Shinkin Central Bank |
| Ashikaga Bank, Ltd. (The) # | Credit Industriel et Commercial | Shoko Chukin Bank, Ltd. (The) |
| BANCA POPOLARE COMMERCIO E INDUSTRIA SPA | Doha Bank Q.S.C. | Silicon Valley Bank |
| Banca Popolare dell'Emilia Romagna Soc. Coop. a r.l. | Dukascopy Bank SA | Swissquote Bank SA also known as: Swissquote Bank AG Swissquote Bank Inc. Swissquote Bank Ltd |
| Banca Popolare di Ancona Societa' per azioni | Fiduciary Trust Company International | Union Bank of Taiwan |
| Banca Popolare di Bergamo S.p.A. | FIRST GULF BANK | Unione di Banche Italiane Società Cooperativa per Azioni |
| Banca Popolare di Sondrio Soc. Coop. a r.l. | Habib Bank A.G. Zurich | Veneto Banca S.c.a.r.l. |
| BANCA POPOLARE DI VICENZA – Società cooperativa per azioni | HSH Nordbank AG | VP Bank Ltd also known as: VP Bank AG VP Bank SA (formerly known as Verwaltungs- und Privat-Bank Aktiengesellschaft) |
| Banca Regionale Europea S.p.A. | Investec Bank Limited | Yamaguchi Bank, Ltd. (The) |
| Banco di Brescia S.p.A. | JAPAN POST BANK CO., LTD. | Yamanashi Chuo Bank, Ltd. |
| Banco Popolare- Societa' Cooperativa | JIH SUN INTERNATIONAL Bank, Ltd. # | Yuanta Commercial Bank Co., Ltd |
| Banco Security | Joint Stock Company TRASTA KOMERCBANKA | Deletion in 2014 |
| Bank Hapoalim (Switzerland) Ltd | Juroku Bank, Ltd. (The) | Banco do Brasil S.A. |
| BANK OF BEIJING CO., LTD. | Korea Development Bank (The) | Bank Leumi Le-Israel B.M. |
| BANK OF DONGGUAN CO., LTD. # | Metropolitan Bank and Trust Company | Credito Bergamasco S.p.A. |
| Bank of Fukuoka, Ltd. (The) | Nanto Bank, Ltd. (The) | |
| Bank of Kyoto, Ltd. (The) | National Bank of Canada | |
| Bank of Yokohama, Ltd. (The) | Nishi-Nippon City Bank, Ltd. (The) | |
| Banque Cantonale de Genève | Norinchukin Bank (The) | |
| BANQUE DEGROOF LUXEMBOURG S.A. | Ogaki Kyoritsu Bank, Ltd. (The) | |
| Banque Transatlantique S.A. | Oita Bank, Ltd. (The) | |
| Central Bank of India | P.T. Bank Central Asia | |
| | P.T. Bank Rakyat Indonesia (Persero) | |
| | Ping An Bank Co., Ltd. | |
| | Resona Bank, Limited | |
| | Rothschild Bank AG | |

Addition in 2014

Table A: Major Economic Indicators

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|--|---------|---------|---------|---------|-------------------------------|
| I. Gross Domestic Product | | | | | |
| Real GDP growth (%) | 6.8 | 4.8 | 1.7 | 2.9 | 2.3 ^[a] |
| Nominal GDP growth (%) | 7.1 | 8.9 | 5.3 | 4.7 | 5.3 ^[a] |
| Real growth of major expenditure components of GDP (%) | | | | | |
| – Private consumption expenditure | 6.1 | 8.4 | 4.1 | 4.6 | 2.7 ^[a] |
| – Government consumption expenditure | 3.4 | 2.5 | 3.6 | 3.0 | 3.1 ^[a] |
| – Gross domestic fixed capital formation of which | 7.7 | 10.2 | 6.8 | 2.2 | (0.3) ^[a] |
| – Building and construction | 5.7 | 15.7 | 7.2 | (4.3) | 6.5 ^[a] |
| – Machinery, equipment and computer software | 6.5 | 12.3 | 10.2 | 10.6 | (5.2) ^[a] |
| – Exports | 16.8 | 3.9 | 1.9 | 6.2 | 0.9 ^[a] |
| – Imports | 17.4 | 4.6 | 2.9 | 6.6 | 1.1 ^[a] |
| GDP at current market prices (US\$ billion) | 228.6 | 248.5 | 262.6 | 274.9 | 289.6 ^[a] |
| Per capita GDP at current market prices (US\$) | 32,550 | 35,142 | 36,708 | 38,241 | 39,994 ^[a] |
| II. External Trade (HK\$ billion) | | | | | |
| Merchandise trade ^[b] | | | | | |
| – Domestic exports of goods | 82.2 | 89.6 | 100.6 | 92.4 | 89.1 ^[a] |
| – Re-exports of goods | 2,986.3 | 3,330.5 | 3,491.2 | 3,724.0 | 3,789.5 ^[a] |
| – Imports of goods | 3,395.1 | 3,848.2 | 4,116.4 | 4,394.9 | 4,471.8 ^[a] |
| – Merchandise trade balance | (326.6) | (428.1) | (524.6) | (578.5) | (593.2) ^[a] |
| Services trade | | | | | |
| – Exports of services | 829.0 | 941.2 | 1,003.0 | 1,058.3 | 1,076.9 ^[a] |
| – Imports of services | 398.1 | 438.6 | 455.4 | 467.2 | 481.2 ^[a] |
| – Services trade balance | 431.0 | 502.6 | 547.7 | 591.1 | 595.7 ^[a] |
| III. Fiscal Expenditure and Revenue (HK\$ million, fiscal year) | | | | | |
| Total government expenditure ^[c] | 301,360 | 364,037 | 377,324 | 433,543 | 406,828 ^[a] |
| Total government revenue | 376,481 | 437,723 | 442,150 | 455,346 | 470,678 ^[a] |
| Consolidated surplus/deficit | 75,121 | 73,686 | 64,825 | 21,803 | 63,850 ^[a] |
| Reserve balance as at end of fiscal year ^[d] | 595,402 | 669,088 | 733,914 | 755,717 | 819,567 ^[a] |
| IV. Prices (annual change, %) | | | | | |
| Consumer Price Index (A) | 2.7 | 5.6 | 3.6 | 5.1 | 5.6 |
| Composite Consumer Price Index | 2.4 | 5.3 | 4.1 | 4.3 | 4.4 |
| Trade Unit Value Indices | | | | | |
| – Domestic exports | 5.5 | 6.4 | 2.5 | 2.2 | (0.3) |
| – Re-exports | 4.6 | 8.0 | 3.4 | 1.3 | 2.0 |
| – Imports | 6.4 | 8.1 | 3.3 | 0.9 | 1.9 |
| Property Price Indices | | | | | |
| – Residential flats | 24.4 | 20.6 | 13.3 | 17.5 | 6.0 ^[a] |
| – Office premises | 28.1 | 29.3 | 12.3 | 22.5 | 3.2 ^[a] |
| – Retail premises | 33.2 | 27.3 | 28.5 | 20.5 | 2.7 ^[a] |
| – Flatted factory premises | 31.5 | 35.4 | 27.2 | 33.8 | 2.0 ^[a] |

Table A: Major Economic Indicators (continued)

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|--|----------|----------|----------|----------|-----------------|
| V. Labour | | | | | |
| Labour force (annual change, %) | {0.8} | 2.0 | 2.2 | 1.9 | 0.5 |
| Employment (annual change, %) | 0.2 | 2.9 | 2.4 | 1.8 | 0.6 |
| Unemployment rate (annual average, %) | 4.3 | 3.4 | 3.3 | 3.4 | 3.3 |
| Underemployment rate (annual average, %) | 2.0 | 1.7 | 1.5 | 1.5 | 1.5 |
| Employment ('000) | 3,474 | 3,576 | 3,661 | 3,728 | 3,749 |
| VI. Money Supply (HK\$ billion) | | | | | |
| HK\$ money supply | | | | | |
| – M1 | 730.1 | 794.7 | 920.9 | 1,000.3 | 1,116.7 |
| – M2 ^(e) | 3,866.8 | 4,046.2 | 4,537.4 | 4,795.1 | 5,225.8 |
| – M3 ^(e) | 3,878.2 | 4,055.4 | 4,545.6 | 4,806.0 | 5,236.2 |
| Total money supply | | | | | |
| – M1 | 1,017.2 | 1,127.3 | 1,377.4 | 1,510.9 | 1,707.6 |
| – M2 | 7,136.3 | 8,057.5 | 8,950.0 | 10,056.4 | 11,012.1 |
| – M3 | 7,156.3 | 8,081.1 | 8,970.4 | 10,085.2 | 11,049.7 |
| VII. Interest Rates (end of period, %) | | | | | |
| Three-month interbank rate ^(f) | 0.28 | 0.38 | 0.40 | 0.38 | 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' | 0.21 | 0.53 | 0.32 | 0.39 | 0.39 |
| VIII. Exchange Rates (end of period) | | | | | |
| HK\$/US\$ | 7.775 | 7.766 | 7.751 | 7.754 | 7.756 |
| Trade-weighted Effective Exchange Rate Index (Jan 2010=100) | 96.3 | 94.9 | 94.2 | 94.8 | 99.0 |
| IX. Foreign Currency Reserve Assets (US\$ billion) ^(g) | 268.7 | 285.4 | 317.4 | 311.2 | 328.5 |
| X. Stock Market (end of period figures) | | | | | |
| Hang Seng Index | 23,035 | 18,434 | 22,657 | 23,306 | 23,605 |
| Average price/earnings ratio | 16.7 | 9.7 | 10.5 | 11.2 | 10.9 |
| Market capitalisation (HK\$ billion) | 20,942.3 | 17,452.7 | 21,871.7 | 23,908.8 | 24,892.4 |

- (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)

(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] With effect from 1 January 2013, a revised capital adequacy framework (Basel III) was introduced for locally incorporated authorized institutions.

Table C Authorized Institutions: Domicile and Parentage

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|--|------|------|------|------|------------|
| Licensed Banks | | | | | |
| (i) Incorporated in Hong Kong | 23 | 23 | 22 | 21 | 21 |
| (ii) Incorporated outside Hong Kong | 123 | 129 | 133 | 135 | 138 |
| Total | 146 | 152 | 155 | 156 | 159 |
| 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 | 6 | 6 | 6 |
| (ii) Subsidiaries or branches of foreign banks which are not licensed banks in Hong Kong | 13 | 12 | 12 | 12 | 11 |
| (iii) Bank related | 1 | 1 | 1 | 1 | 1 |
| (iv) Others | 1 | 1 | 1 | 1 | 2 |
| Total | 21 | 20 | 21 | 21 | 21 |
| Deposit-taking Companies | | | | | |
| (i) Subsidiaries of licensed banks: | | | | | |
| (a) incorporated in Hong Kong | 6 | 6 | 6 | 6 | 6 |
| (b) incorporated outside Hong Kong | 4 | 4 | 3 | 3 | 3 |
| (ii) Subsidiaries of foreign banks which are not licensed banks in Hong Kong | 7 | 7 | 7 | 7 | 6 |
| (iii) Bank related | 2 | 2 | 2 | 2 | 2 |
| (iv) Others | 7 | 7 | 6 | 6 | 6 |
| Total | 26 | 26 | 24 | 24 | 23 |
| All Authorized Institutions | 193 | 198 | 200 | 201 | 203 |
| Local Representative Offices | 67 | 61 | 60 | 62 | 63 |

Table D Authorized Institutions: Region/Economy of Beneficial Ownership

| Region/Economy | Licensed Banks | | | | | Restricted Licence Banks | | | | | Deposit-taking Companies | | | | |
|-------------------------------------|----------------|-----|-----|-----|------------|--------------------------|----|----|----|-----------|--------------------------|----|----|----|-----------|
| | 10 | 11 | 12 | 13 | 14 | 10 | 11 | 12 | 13 | 14 | 10 | 11 | 12 | 13 | 14 |
| Asia & Pacific | | | | | | | | | | | | | | | |
| Hong Kong | 10 | 10 | 9 | 9 | 7 | – | – | – | – | – | 7 | 7 | 7 | 7 | 4 |
| Australia | 4 | 5 | 5 | 5 | 5 | – | – | – | – | – | – | – | – | – | – |
| Mainland China | 14 | 15 | 17 | 17 | 19 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 3 |
| 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 | 11 | 11 | 1 | 1 | 1 | 1 | 1 | 3 | 3 | 2 | 2 | 1 |
| Malaysia | 3 | 3 | 3 | 4 | 4 | – | – | – | – | – | 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 | 5 | 5 | 5 | 5 | 6 | – | – | – | – | – | – | – | – | – | 2 |
| South Korea | 5 | 5 | 5 | 5 | 5 | 2 | 2 | 2 | 2 | 2 | 4 | 4 | 4 | 4 | 4 |
| Taiwan | 19 | 19 | 19 | 19 | 19 | – | – | – | – | – | 1 | 1 | 1 | 1 | 1 |
| Thailand | 1 | 1 | 1 | 1 | 1 | 4 | 3 | 3 | 3 | 3 | – | – | – | – | – |
| Vietnam | – | – | – | – | – | – | – | – | – | – | 1 | 1 | 1 | 1 | 1 |
| Sub-Total | 87 | 89 | 90 | 92 | 93 | 11 | 10 | 10 | 10 | 10 | 24 | 24 | 23 | 23 | 22 |
| Europe | | | | | | | | | | | | | | | |
| Austria | 1 | 1 | 2 | 2 | 2 | – | – | – | – | – | – | – | – | – | – |
| Belgium | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | – | – | – | – | – |
| Denmark | – | – | – | – | – | – | – | – | – | – | – | – | – | – | – |
| France | 9 | 9 | 9 | 9 | 9 | 3 | 2 | 2 | 2 | 2 | – | – | – | – | – |
| Germany | 4 | 4 | 4 | 4 | 4 | – | – | – | – | – | – | – | – | – | – |
| Italy | 4 | 4 | 4 | 4 | 4 | – | – | – | – | – | – | – | – | – | – |
| Luxembourg | – | – | – | – | – | 1 | 1 | – | – | – | – | – | – | – | – |
| Netherlands | 4 | 4 | 3 | 3 | 3 | – | – | – | – | – | – | – | – | – | – |
| Spain | 2 | 2 | 2 | 2 | 2 | – | – | – | – | – | – | – | – | – | – |
| Sweden | 1 | 2 | 2 | 2 | 2 | – | – | – | – | – | – | – | – | – | – |
| Switzerland | 4 | 5 | 6 | 6 | 6 | – | – | – | – | – | – | – | – | – | – |
| United Kingdom | 11 | 11 | 11 | 11 | 11 | – | – | – | – | – | 1 | 1 | 1 | 1 | 1 |
| Sub-Total | 41 | 43 | 44 | 44 | 44 | 5 | 4 | 3 | 3 | 3 | 1 | 1 | 1 | 1 | 1 |
| Middle East | | | | | | | | | | | | | | | |
| Bahrain | – | – | – | – | – | – | – | – | – | – | – | – | – | – | – |
| Iran | 1 | 1 | 1 | 1 | 1 | – | – | – | – | – | – | – | – | – | – |
| United Arab Emirates | 2 | 2 | 2 | 2 | 3 | 1 | 1 | 1 | 1 | – | – | – | – | – | – |
| Sub-Total | 3 | 3 | 3 | 3 | 4 | 1 | 1 | 1 | 1 | – | – | – | – | – | – |
| North America | | | | | | | | | | | | | | | |
| Canada | 5 | 5 | 5 | 5 | 5 | 1 | 1 | 3 | 3 | 3 | – | – | – | – | – |
| United States | 9 | 9 | 9 | 9 | 10 | 3 | 4 | 4 | 4 | 5 | 1 | 1 | – | – | – |
| Sub-Total | 14 | 14 | 14 | 14 | 15 | 4 | 5 | 7 | 7 | 8 | 1 | 1 | – | – | – |
| South Africa | 1 | 2 | 2 | 1 | 1 | – | – | – | – | – | – | – | – | – | – |
| Bermuda | – | – | – | – | – | – | – | – | – | – | – | – | – | – | – |
| Others | – | 1 | 2 | 2 | 2 | – | – | – | – | – | – | – | – | – | – |
| Addition in 2009 Grand Total | 146 | 152 | 155 | 156 | 159 | 21 | 20 | 21 | 21 | 21 | 26 | 26 | 24 | 24 | 23 |

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

| Positions at 31 December 2014 | Number of Overseas Banks ^[b] | | | | | Licensed Banks ^[c] | | | | | Restricted Licence Banks ^[c] | | | | | Deposit-Taking Companies ^[c] | | | | | Local Representative Offices | | | | |
|-------------------------------------|---|-----|-----|-----|------------|-------------------------------|-----|-----|-----|------------|---|----|----|----|-----------|---|----|----|----|-----------|------------------------------|----|----|----|-----------|
| | 10 | 11 | 12 | 13 | 14 | 10 | 11 | 12 | 13 | 14 | 10 | 11 | 12 | 13 | 14 | 10 | 11 | 12 | 13 | 14 | 10 | 11 | 12 | 13 | 14 |
| World Ranking ^[a] | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1 – 20 | 20 | 20 | 20 | 20 | 20 | 38 | 40 | 39 | 40 | 39 | 6 | 6 | 6 | 5 | 5 | – | – | – | – | – | 5 | 3 | 2 | – | – |
| 21 – 50 | 23 | 26 | 26 | 26 | 25 | 24 | 21 | 23 | 24 | 24 | 3 | 3 | 3 | 3 | 4 | 2 | 2 | 2 | 2 | 2 | 3 | 5 | 5 | 4 | 3 |
| 51 – 100 | 27 | 27 | 24 | 24 | 26 | 17 | 21 | 22 | 23 | 25 | 1 | 1 | 1 | 2 | 2 | 3 | 3 | 3 | 3 | 4 | 16 | 14 | 3 | 4 | 5 |
| 101 – 200 | 30 | 40 | 40 | 43 | 38 | 17 | 23 | 25 | 24 | 23 | – | – | – | 3 | 3 | 3 | 4 | 3 | 2 | 1 | 12 | 14 | 21 | 22 | 18 |
| 201 – 500 | 51 | 43 | 48 | 47 | 52 | 30 | 24 | 25 | 26 | 28 | 6 | 5 | 5 | 4 | 3 | 1 | 2 | 3 | 3 | 4 | 16 | 14 | 17 | 16 | 19 |
| Sub-total | 151 | 156 | 158 | 160 | 161 | 126 | 129 | 134 | 137 | 139 | 16 | 15 | 15 | 17 | 17 | 9 | 11 | 11 | 10 | 11 | 52 | 50 | 48 | 46 | 45 |
| Others | 48 | 43 | 42 | 45 | 47 | 20 | 23 | 21 | 19 | 20 | 5 | 5 | 6 | 4 | 4 | 17 | 15 | 13 | 14 | 12 | 15 | 11 | 12 | 16 | 18 |
| Total | 199 | 199 | 200 | 205 | 208 | 146 | 152 | 155 | 156 | 159 | 21 | 20 | 21 | 21 | 21 | 26 | 26 | 24 | 24 | 23 | 67 | 61 | 60 | 62 | 63 |

(a) Top 500 banks/banking groups in the world ranked by total assets. Figures are extracted from The Banker, July 2014 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) | 2010 | | | 2011 | | | 2012 | | | 2013 | | | 2014 | | |
|--|--------------|--------------|---------------|--------------|--------------|---------------|--------------|--------------|---------------|--------------|---------------|---------------|--------------|---------------|---------------|
| | HK\$ | F/CY | Total | HK\$ | F/CY | Total | HK\$ | F/CY | Total | HK\$ | F/CY | Total | HK\$ | F/CY | Total |
| Assets | | | | | | | | | | | | | | | |
| Loans to customers | 2,824 | 1,403 | 4,228 | 3,160 | 1,921 | 5,081 | 3,333 | 2,234 | 5,567 | 3,606 | 2,851 | 6,457 | 4,000 | 3,276 | 7,276 |
| – Inside Hong Kong ^[a] | 2,568 | 695 | 3,262 | 2,809 | 902 | 3,711 | 2,934 | 1,046 | 3,980 | 3,119 | 1,410 | 4,529 | 3,468 | 1,607 | 5,075 |
| – Outside Hong Kong ^[b] | 257 | 708 | 965 | 351 | 1,018 | 1,369 | 399 | 1,188 | 1,587 | 487 | 1,441 | 1,928 | 532 | 1,668 | 2,201 |
| Interbank lending | 399 | 3,743 | 4,142 | 351 | 4,120 | 4,471 | 390 | 3,999 | 4,389 | 424 | 4,372 | 4,795 | 430 | 4,941 | 5,372 |
| – Inside Hong Kong | 181 | 473 | 654 | 205 | 444 | 649 | 234 | 424 | 658 | 255 | 528 | 783 | 254 | 598 | 852 |
| – Outside Hong Kong | 218 | 3,270 | 3,488 | 146 | 3,676 | 3,822 | 157 | 3,575 | 3,731 | 169 | 3,843 | 4,012 | 176 | 4,344 | 4,520 |
| Negotiable certificates of deposit (NCDs) | 80 | 54 | 133 | 90 | 104 | 194 | 133 | 159 | 291 | 134 | 173 | 306 | 123 | 144 | 267 |
| Negotiable debt instruments, other than NCDs | 893 | 1,737 | 2,630 | 862 | 1,865 | 2,727 | 822 | 2,117 | 2,939 | 912 | 2,676 | 3,588 | 884 | 2,625 | 3,509 |
| Other assets | 550 | 608 | 1,158 | 566 | 704 | 1,270 | 775 | 897 | 1,672 | 726 | 1,069 | 1,795 | 848 | 1,164 | 2,012 |
| Total assets | 4,746 | 7,545 | 12,291 | 5,029 | 8,713 | 13,742 | 5,453 | 9,406 | 14,859 | 5,801 | 11,141 | 16,941 | 6,286 | 12,150 | 18,436 |
| Liabilities | | | | | | | | | | | | | | | |
| Deposits from customers ^[c] | 3,617 | 3,245 | 6,862 | 3,740 | 3,851 | 7,591 | 4,176 | 4,120 | 8,296 | 4,391 | 4,789 | 9,180 | 4,800 | 5,274 | 10,074 |
| Interbank borrowing | 466 | 3,222 | 3,688 | 547 | 3,479 | 4,026 | 576 | 3,393 | 3,969 | 612 | 4,103 | 4,715 | 695 | 4,310 | 5,005 |
| – Inside Hong Kong | 178 | 478 | 657 | 201 | 450 | 651 | 236 | 434 | 670 | 310 | 602 | 912 | 329 | 686 | 1,015 |
| – Outside Hong Kong | 288 | 2,744 | 3,032 | 346 | 3,029 | 3,375 | 340 | 2,959 | 3,299 | 302 | 3,502 | 3,803 | 366 | 3,624 | 3,990 |
| Negotiable certificates of deposit | 114 | 61 | 175 | 144 | 239 | 383 | 210 | 426 | 636 | 222 | 616 | 838 | 213 | 631 | 845 |
| Other liabilities | 845 | 720 | 1,565 | 910 | 831 | 1,741 | 1,033 | 924 | 1,957 | 1,133 | 1,075 | 2,208 | 1,202 | 1,310 | 2,513 |
| Total liabilities | 5,043 | 7,248 | 12,291 | 5,341 | 8,401 | 13,742 | 5,996 | 8,863 | 14,859 | 6,357 | 10,584 | 16,941 | 6,911 | 11,525 | 18,436 |

Retail Banks

| (HK\$ billion) | 2010 | | | 2011 | | | 2012 | | | 2013 | | | 2014 | | |
|--|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|--------------|--------------|---------------|
| | HK\$ | F/CY | Total | HK\$ | F/CY | Total |
| Assets | | | | | | | | | | | | | | | |
| Loans to customers | 2,310 | 622 | 2,932 | 2,567 | 784 | 3,351 | 2,724 | 906 | 3,630 | 2,966 | 1,195 | 4,161 | 3,264 | 1,397 | 4,660 |
| – Inside Hong Kong ^[a] | 2,150 | 392 | 2,542 | 2,346 | 462 | 2,808 | 2,477 | 519 | 2,996 | 2,664 | 750 | 3,414 | 2,940 | 830 | 3,769 |
| – Outside Hong Kong ^[b] | 160 | 230 | 391 | 221 | 322 | 543 | 248 | 386 | 634 | 302 | 445 | 747 | 324 | 567 | 891 |
| Interbank lending | 172 | 1,439 | 1,611 | 172 | 1,639 | 1,811 | 200 | 1,449 | 1,648 | 207 | 1,764 | 1,972 | 236 | 2,092 | 2,327 |
| – Inside Hong Kong | 112 | 284 | 396 | 123 | 205 | 329 | 152 | 186 | 337 | 148 | 174 | 322 | 156 | 257 | 413 |
| – Outside Hong Kong | 60 | 1,155 | 1,215 | 49 | 1,433 | 1,482 | 48 | 1,263 | 1,311 | 59 | 1,590 | 1,649 | 80 | 1,835 | 1,915 |
| Negotiable certificates of deposit (NCDs) | 54 | 27 | 81 | 57 | 47 | 104 | 90 | 90 | 180 | 101 | 112 | 213 | 96 | 80 | 177 |
| Negotiable debt instruments, other than NCDs | 620 | 1,257 | 1,876 | 620 | 1,314 | 1,934 | 618 | 1,509 | 2,127 | 709 | 1,791 | 2,500 | 677 | 1,727 | 2,403 |
| Other assets | 432 | 396 | 828 | 438 | 470 | 908 | 589 | 600 | 1,189 | 580 | 722 | 1,302 | 669 | 813 | 1,482 |
| Total assets | 3,588 | 3,740 | 7,328 | 3,855 | 4,253 | 8,108 | 4,220 | 4,554 | 8,774 | 4,563 | 5,584 | 10,148 | 4,942 | 6,108 | 11,050 |
| Liabilities | | | | | | | | | | | | | | | |
| Deposits from customers ^[c] | 3,276 | 2,280 | 5,556 | 3,368 | 2,692 | 6,059 | 3,768 | 2,854 | 6,622 | 3,967 | 3,432 | 7,398 | 4,374 | 3,735 | 8,109 |
| Interbank borrowing | 136 | 486 | 622 | 165 | 523 | 687 | 183 | 475 | 658 | 238 | 768 | 1,006 | 295 | 714 | 1,010 |
| – Inside Hong Kong | 41 | 291 | 332 | 55 | 246 | 301 | 59 | 181 | 240 | 133 | 364 | 497 | 150 | 349 | 499 |
| – Outside Hong Kong | 95 | 195 | 290 | 109 | 277 | 386 | 123 | 294 | 417 | 105 | 404 | 510 | 145 | 366 | 511 |
| Negotiable certificates of deposit | 41 | 22 | 63 | 64 | 99 | 163 | 45 | 123 | 168 | 57 | 175 | 232 | 64 | 176 | 239 |
| Other liabilities | 682 | 406 | 1,088 | 720 | 478 | 1,198 | 825 | 501 | 1,326 | 915 | 596 | 1,511 | 954 | 737 | 1,691 |
| Total liabilities | 4,134 | 3,194 | 7,328 | 4,316 | 3,792 | 8,108 | 4,820 | 3,954 | 8,774 | 5,177 | 4,971 | 10,148 | 5,687 | 5,362 | 11,050 |

(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 | 2013 | 4,941 | 1,215 | 998 | 2,796 | 6,991 | 16,941 |
| | 2014 | 5,768 | 1,380 | 977 | 2,933 | 7,378 | 18,436 |
| Deposits from Customers | 2013 | 2,760 | 166 | 440 | 1,337 | 4,478 | 9,180 |
| | 2014 | 3,359 | 180 | 447 | 1,378 | 4,710 | 10,074 |
| Loans to Customers | 2013 | 2,052 | 466 | 230 | 982 | 2,727 | 6,457 |
| | 2014 | 2,366 | 512 | 248 | 1,121 | 3,030 | 7,276 |
| Loans to Customers | 2013 | 1,417 | 260 | 198 | 614 | 2,039 | 4,529 |
| Inside Hong Kong ^(a) | 2014 | 1,580 | 289 | 206 | 721 | 2,279 | 5,075 |
| Loans to Customers | 2013 | 634 | 206 | 32 | 368 | 688 | 1,928 |
| Outside Hong Kong ^(b) | 2014 | 786 | 223 | 42 | 400 | 750 | 2,201 |

(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) | 2013 | | | 2014 | | |
|--|------------|--------------|--------------|-------------|--------------|--------------|
| | HK\$ | F/CY | Total | HK\$ | F/CY | Total |
| Assets | | | | | | |
| Loans to customers | 273 | 617 | 890 | 394 | 425 | 819 |
| – Inside Hong Kong ^[a] | 186 | 364 | 549 | 349 | 198 | 546 |
| – Outside Hong Kong ^[b] | 87 | 253 | 341 | 46 | 227 | 273 |
| Interbank lending | 33 | 373 | 406 | 7 | 569 | 576 |
| – Inside Hong Kong | 21 | 105 | 126 | (1) | 69 | 69 |
| – Outside Hong Kong | 12 | 269 | 281 | 8 | 500 | 508 |
| All other assets | 42 | 744 | 786 | 84 | 15 | 99 |
| Total assets | 348 | 1,735 | 2,083 | 485 | 1,009 | 1,494 |
| Liabilities | | | | | | |
| Deposits from customers ^[c] | 215 | 669 | 884 | 409 | 484 | 894 |
| Interbank borrowing | 36 | 710 | 746 | 84 | 206 | 290 |
| – Inside Hong Kong | 74 | 168 | 242 | 19 | 84 | 103 |
| – Outside Hong Kong | (38) | 542 | 504 | 65 | 122 | 187 |
| All other liabilities | 111 | 342 | 453 | 61 | 250 | 311 |
| Total liabilities | 362 | 1,721 | 2,083 | 554 | 941 | 1,494 |
| Net Interbank Borrowing/(Lending) | 3 | 337 | 339 | 77 | (363) | (287) |
| Net Customer Lending/(Borrowing) | 58 | (52) | 6 | (15) | (60) | (75) |

Retail Banks

| Increase/(Decrease) in (HK\$ billion) | 2013 | | | 2014 | | |
|--|------------|--------------|--------------|--------------|--------------|--------------|
| | HK\$ | F/CY | Total | HK\$ | F/CY | Total |
| Assets | | | | | | |
| Loans to customers | 242 | 289 | 531 | 298 | 202 | 499 |
| – Inside Hong Kong ^[a] | 187 | 231 | 418 | 276 | 79 | 355 |
| – Outside Hong Kong ^[b] | 54 | 58 | 113 | 22 | 122 | 144 |
| Interbank lending | 8 | 316 | 323 | 29 | 327 | 356 |
| – Inside Hong Kong | (3) | (12) | (15) | 7 | 83 | 91 |
| – Outside Hong Kong | 11 | 328 | 338 | 21 | 244 | 265 |
| All other assets | 94 | 425 | 519 | 52 | (6) | 47 |
| Total assets | 343 | 1,030 | 1,373 | 379 | 523 | 902 |
| Liabilities | | | | | | |
| Deposits from customers ^[c] | 199 | 578 | 777 | 408 | 303 | 711 |
| Interbank borrowing | 55 | 293 | 349 | 57 | (54) | 3 |
| – Inside Hong Kong | 73 | 183 | 256 | 18 | (16) | 2 |
| – Outside Hong Kong | (18) | 110 | 92 | 39 | (38) | 1 |
| All other liabilities | 102 | 146 | 248 | 46 | 142 | 188 |
| Total liabilities | 356 | 1,017 | 1,373 | 511 | 391 | 902 |
| Net Interbank Borrowing/(Lending) | 48 | (23) | 25 | 29 | (381) | (353) |
| Net Customer Lending/(Borrowing) | 43 | (288) | (246) | (110) | (102) | (211) |

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

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

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

Figures may not add up to total because of rounding.

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

| (HK\$ billion) | Loans to Customers | | | | Deposits from Customers ^[a] | | | |
|---------------------------------|--------------------|--------------|--------------|------------|--|--------------|---------------|------------|
| | HK\$ | F/CY | Total | % | HK\$ | F/CY | Total | % |
| 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 | 3,561 | 2,823 | 6,384 | 99 | 4,380 | 4,772 | 9,152 | 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 | 4,789 | 9,180 | 100 |
| 2014 | | | | | | | | |
| Licensed banks | 3,954 | 3,241 | 7,195 | 99 | 4,790 | 5,249 | 10,039 | 100 |
| Restricted licence banks | 22 | 29 | 51 | 1 | 5 | 22 | 27 | - |
| Deposit-taking companies | 24 | 6 | 30 | - | 5 | 2 | 7 | - |
| Total | 4,000 | 3,276 | 7,276 | 100 | 4,800 | 5,274 | 10,074 | 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 (HK\$ billion) | 2010 | | 2011 | | 2012 | | 2013 | | 2014 | |
|---|--------------|------------|--------------|------------|--------------|------------|--------------|------------|--------------|------------|
| | HK\$ | % |
| Hong Kong's visible trade | 274 | 8 | 351 | 9 | 383 | 10 | 550 | 12 | 543 | 11 |
| Manufacturing | 162 | 5 | 189 | 5 | 184 | 5 | 216 | 5 | 271 | 5 |
| Transport and transport equipment | 168 | 5 | 193 | 5 | 216 | 5 | 247 | 5 | 261 | 5 |
| Building, construction and property development, and investment | 827 | 25 | 918 | 25 | 928 | 23 | 994 | 22 | 1,062 | 21 |
| Wholesale and retail trade | 229 | 7 | 314 | 8 | 351 | 9 | 418 | 9 | 474 | 9 |
| Financial concerns (other than authorized institutions) | 235 | 7 | 264 | 7 | 273 | 7 | 327 | 7 | 390 | 8 |
| Individuals: | | | | | | | | | | |
| – to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme | 51 | 2 | 46 | 1 | 42 | 1 | 42 | 1 | 42 | 1 |
| – to purchase other residential properties | 745 | 23 | 805 | 22 | 873 | 22 | 909 | 20 | 988 | 19 |
| – other purposes | 256 | 8 | 292 | 8 | 333 | 8 | 390 | 9 | 450 | 9 |
| Others | 315 | 10 | 340 | 9 | 397 | 10 | 437 | 10 | 595 | 12 |
| Total^[a] | 3,262 | 100 | 3,711 | 100 | 3,980 | 100 | 4,529 | 100 | 5,075 | 100 |

Retail Banks

| Sector (HK\$ billion) | 2010 | | 2011 | | 2012 | | 2013 | | 2014 | |
|---|--------------|------------|--------------|------------|--------------|------------|--------------|------------|--------------|------------|
| | HK\$ | % |
| Hong Kong's visible trade | 208 | 8 | 242 | 9 | 257 | 9 | 349 | 10 | 316 | 8 |
| Manufacturing | 114 | 4 | 129 | 5 | 121 | 4 | 139 | 4 | 163 | 4 |
| Transport and transport equipment | 102 | 4 | 115 | 4 | 129 | 4 | 156 | 5 | 176 | 5 |
| Building, construction and property development, and investment | 663 | 26 | 719 | 26 | 734 | 24 | 786 | 23 | 830 | 22 |
| Wholesale and retail trade | 161 | 6 | 207 | 7 | 222 | 7 | 266 | 8 | 310 | 8 |
| Financial concerns (other than authorized institutions) | 106 | 4 | 113 | 4 | 118 | 4 | 169 | 5 | 203 | 5 |
| Individuals: | | | | | | | | | | |
| – to purchase flats in the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme | 51 | 2 | 46 | 2 | 42 | 1 | 42 | 1 | 42 | 1 |
| – to purchase other residential properties | 734 | 29 | 794 | 28 | 860 | 29 | 896 | 26 | 976 | 26 |
| – other purposes | 209 | 8 | 245 | 9 | 270 | 9 | 320 | 9 | 362 | 10 |
| Others | 193 | 8 | 199 | 7 | 243 | 8 | 291 | 9 | 393 | 10 |
| Total^[a] | 2,542 | 100 | 2,808 | 100 | 2,996 | 100 | 3,414 | 100 | 3,769 | 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) | | | | | | | | |
| 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 |
| 2014 | 787 | 2,242 | 1,772 | 4,800 | 700 | 2,206 | 1,468 | 4,374 |
| Foreign Currency | | | | | | | | |
| 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 | 2,659 | 4,789 | 305 | 1,401 | 1,726 | 3,432 |
| 2014 | 591 | 1,723 | 2,960 | 5,274 | 347 | 1,514 | 1,873 | 3,735 |
| Total | | | | | | | | |
| 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 | 4,287 | 9,180 | 914 | 3,449 | 3,035 | 7,398 |
| 2014 | 1,377 | 3,965 | 4,731 | 10,074 | 1,048 | 3,720 | 3,341 | 8,109 |

(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) | 2013 | | | 2014 | | |
|----------------------------------|--|---|---------------------------------------|---------------------------------------|---|---------------------------------------|
| | Net Claims on/ Banks Outside Hong Kong | Net Claims on/ (Liabilities to) Non-Bank Customers Outside Hong Kong | | Total Net Claims/ (Liabilities) | Net Claims on/ (Liabilities to) Non-Bank Customers Outside Hong Kong | |
| | | Net Claims on/ (Liabilities to) | Total Net Claims/ (Liabilities) | | Net Claims on/ Banks Outside Hong Kong | Total Net Claims/ (Liabilities) |
| Asia & Pacific | 2,284 | (81) | 2,203 | 2,221 | (149) | 2,071 |
| Mainland China | 2,180 | 138 | 2,318 | 2,127 | 119 | 2,247 |
| South Korea | 155 | 23 | 179 | 167 | (25) | 142 |
| India | 56 | 92 | 149 | 32 | 102 | 134 |
| Australia | 154 | 22 | 176 | 85 | 28 | 113 |
| Malaysia | 66 | (15) | 51 | 55 | (21) | 34 |
| Indonesia | 8 | 6 | 14 | 16 | 13 | 29 |
| Bangladesh | 7 | [0] | 7 | 10 | 1 | 11 |
| Sri Lanka | 5 | 2 | 7 | 7 | 1 | 9 |
| Laos | 5 | 0 | 5 | 4 | 1 | 4 |
| Vietnam | 5 | 2 | 8 | (1) | 4 | 3 |
| Pakistan | 0 | 0 | 1 | 2 | 1 | 2 |
| Papua New Guinea | (1) | 1 | [0] | [0] | 2 | 1 |
| Myanmar | [0] | [0] | (1) | [0] | [0] | (1) |
| Vanuatu | 0 | (1) | (1) | 0 | (1) | (1) |
| New Zealand | 3 | (3) | [0] | 3 | (5) | (2) |
| Cambodia | 2 | 2 | 5 | (2) | (2) | (4) |
| Kazakhstan | [0] | (2) | (2) | [0] | (5) | (6) |
| Brunei | (5) | (2) | (7) | (4) | (2) | (6) |
| Philippines | (8) | (4) | (12) | (6) | (2) | (9) |
| Nepal | (6) | [0] | (6) | (10) | (2) | (11) |
| Western Samoa | [0] | (17) | (17) | 0 | (22) | (22) |
| Thailand | 38 | (44) | (6) | 41 | (67) | (26) |
| Taiwan | 230 | (242) | (12) | 216 | (257) | (42) |
| Singapore | 7 | (93) | (86) | 5 | (97) | (92) |
| Macau SAR | (49) | (41) | (90) | (139) | 3 | (136) |
| Japan | (564) | 89 | (475) | (382) | 85 | (297) |
| Others | (3) | 4 | 1 | (5) | 1 | (4) |
| North America | (53) | 223 | 170 | 41 | 278 | 319 |
| United States | (51) | 187 | 136 | 60 | 246 | 307 |
| Canada | (2) | 36 | 34 | (20) | 31 | 12 |
| Caribbean | (9) | (74) | (83) | (28) | (67) | (96) |
| Bahamas | (4) | 3 | (1) | (9) | 8 | (1) |
| Cayman Islands | (7) | 14 | 7 | (19) | 13 | (6) |
| Barbados | 0 | (5) | (5) | 0 | (6) | (6) |
| Panama | 3 | (1) | 1 | (0) | (6) | (6) |
| Bermuda | (1) | (10) | (10) | (0) | (10) | (10) |
| Others | (1) | (75) | (76) | (0) | (67) | (67) |
| Africa | 3 | (57) | (54) | 6 | (25) | (19) |
| Mauritius | 6 | (2) | 5 | 11 | 1 | 12 |
| Kenya | 0 | 0 | 1 | 0 | 1 | 1 |
| Liberia | 0 | (1) | (1) | 0 | (1) | (1) |
| South Africa | 0 | (2) | (2) | (0) | (1) | (2) |
| Nigeria | (4) | 0 | (4) | (4) | 0 | (4) |
| Others | 0 | (52) | (52) | (1) | (25) | (26) |

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

| Region/Economy (HK\$ billion) | 2013 | | | 2014 | | |
|----------------------------------|--|---|---------------------------------------|--|---|---------------------------------------|
| | Net Claims on/ Banks Outside Hong Kong | Non-Bank Customers Outside Hong Kong | Total Net Claims/ (Liabilities) | Net Claims on/ Banks Outside Hong Kong | Non-Bank Customers Outside Hong Kong | Total Net Claims/ (Liabilities) |
| | Net Claims on/ (Liabilities to) | Net Claims on/ (Liabilities to) | Net Claims on/ (Liabilities to) | Net Claims on/ (Liabilities to) | Net Claims on/ (Liabilities to) | Net Claims on/ (Liabilities to) |
| Latin America | 8 | (1) | 6 | 15 | 2 | 18 |
| Venezuela | 6 | (1) | 5 | 13 | (1) | 12 |
| Peru | 0 | 4 | 4 | 0 | 6 | 7 |
| Mexico | 1 | 2 | 2 | 1 | 4 | 5 |
| Brazil | 1 | 1 | 1 | 2 | (0) | 2 |
| Chile | 0 | (2) | (1) | 0 | (0) | (0) |
| Argentina | 0 | (0) | (0) | (0) | (1) | (1) |
| Others | 0 | (4) | (4) | 0 | (6) | (6) |
| Eastern Europe | 4 | (2) | 2 | (2) | (7) | (9) |
| Western Europe | (157) | 84 | (73) | (179) | 86 | (93) |
| Germany | 12 | 35 | 47 | 49 | 34 | 83 |
| United Kingdom | 47 | (3) | 44 | 38 | 8 | 46 |
| Luxembourg | 34 | 2 | 36 | 15 | 3 | 18 |
| Norway | 8 | 1 | 9 | 6 | 1 | 8 |
| Ireland | (0) | 8 | 8 | (0) | 6 | 6 |
| Sweden | 3 | 4 | 6 | 3 | 1 | 4 |
| Turkey | 6 | 0 | 6 | 2 | 0 | 3 |
| France | (9) | 37 | 29 | (39) | 41 | 2 |
| Finland | 1 | (0) | 1 | (0) | 1 | 1 |
| Denmark | 1 | (0) | 0 | 1 | 0 | 1 |
| Jersey | 7 | (3) | 4 | 4 | (3) | 1 |
| Liechtenstein | (1) | (0) | (2) | 0 | (0) | (0) |
| Cyprus | (0) | (0) | (0) | (0) | (1) | (1) |
| Gibraltar | 0 | (1) | (1) | 0 | (1) | (1) |
| Greece | (0) | (1) | (1) | (0) | (1) | (1) |
| Guernsey | 2 | (1) | 0 | 0 | (3) | (3) |
| Malta | (6) | 1 | (5) | (4) | 0 | (4) |
| Belgium | (28) | (3) | (31) | (4) | (0) | (4) |
| Austria | 1 | (0) | 0 | (8) | 0 | (8) |
| Spain | (54) | (1) | (55) | (18) | (1) | (19) |
| Switzerland | 12 | (15) | (2) | (14) | (15) | (29) |
| Italy | (52) | (3) | (55) | (58) | (4) | (63) |
| Netherlands | (141) | 29 | (111) | (152) | 16 | (136) |
| Others | (0) | 0 | 0 | 0 | 4 | 4 |
| Middle East | 18 | 27 | 45 | 10 | 6 | 15 |
| United Arab Emirates | 18 | 17 | 35 | 24 | 1 | 25 |
| Bahrain | 16 | 1 | 17 | 16 | (0) | 15 |
| Qatar | 2 | 4 | 6 | 0 | 3 | 3 |
| Egypt | (1) | 1 | 1 | (0) | 1 | 1 |
| Oman | (1) | 1 | (1) | (0) | 1 | 1 |
| Iraq | 0 | 0 | 0 | 0 | 1 | 1 |
| Israel | (0) | (1) | (2) | (1) | (2) | (3) |
| Saudi Arabia | (6) | 9 | 3 | (21) | 8 | (13) |
| Kuwait | (10) | (4) | (15) | (8) | (8) | (16) |
| Others | (0) | 0 | 0 | 0 | (0) | 0 |
| Others^[a] | 68 | 1 | 69 | 62 | 3 | 65 |
| Overall Total | 2,165 | 120 | 2,285 | 2,145 | 127 | 2,272 |

(a) "Others" include economies not listed above and positions in relation to international organisations.
Figures may not add up to total because of rounding.

Abbreviations used in this Report

| | | | |
|--------|--|--------------|--|
| AI | - Authorized institution | HKICL | - Hong Kong Interbank Clearing Limited |
| APEC | - Asia-Pacific Economic Co-operation | HKICPA | - Hong Kong Institute of Certified Public Accountants |
| AML | - Anti-money laundering | HKIMR | - Hong Kong Institute for Monetary Research |
| ASEAN | - Association of Southeast Asian Nations | HKMA | - Hong Kong Monetary Authority |
| BCR | - Banking [Capital] Rules | HKMC | - Hong Kong Mortgage Corporation Limited |
| BDR | - Banking [Disclosure] Rules | HKSAR | - Hong Kong Special Administrative Region |
| BIS | - Bank for International Settlements | HKSI | - Hong Kong Securities and Investment Institute |
| BLR | - Banking [Liquidity] Rules | IASB | - International Accounting Standards Board |
| CCyB | - Countercyclical capital buffer | iBonds | - Inflation-linked retail bonds |
| CEPA | - Closer Economic Partnership Arrangement | ILAS | - Investment-linked assurance scheme |
| CFT | - Counter-terrorist financing | IMF | - International Monetary Fund |
| CHATS | - Clearing House Automated Transfer System | IMM approach | - Internal models approach |
| CMIM | - Chiang Mai Initiative Multilateralisation | IOSCO | - International Organization of Securities Commissions |
| CMU | - Central Moneymarkets Unit | IRB approach | - Internal ratings-based approach |
| CSDs | - Central Securities Depositories | ISC | - Investment Sub-Committee |
| CSSO | - Clearing and Settlement Systems Ordinance | LegCo | - Legislative Council |
| CTC | - Corporate treasury centre | LERS | - Linked Exchange Rate system |
| CUs | - Convertibility Undertakings | LIBOR | - London Interbank Offered Rate |
| DPS | - Deposit Protection Scheme | LTGP | - Long-Term Growth Portfolio |
| DSR | - Debt servicing ratio | MPF | - Mandatory Provident Fund |
| D-SIBs | - Domestic systemically important banks | NDIs | - Negotiable debt instruments |
| DvP | - Delivery-versus-Payment | NFC | - Near Field Communication |
| EBPP | - Electronic Bill Presentment and Payment | NLTI | - Non-linked long term insurance |
| ECF | - Enhanced competency framework | OCI | - Office of the Commissioner of Insurance |
| EFAC | - Exchange Fund Advisory Committee | OCL | - Octopus Cards Limited |
| EFBN | - Exchange Fund Bills and Notes | OECD | - Organisation for Economic Co-operation and Development |
| EMEAP | - Executives' Meeting of East Asia-Pacific Central Banks | OTC | - Over-the-counter |
| FASB | - Financial Accounting Standards Board | PBoC | - People's Bank of China |
| FMIs | - Financial market infrastructures | PLPs | - Primary Liquidity Providers |
| FS | - Financial Secretary | PvP | - Payment-versus-Payment |
| FSB | - Financial Stability Board | RMB | - Renminbi |
| FSAP | - Financial Sector Assessment Program | RPS | - Retail Payment Systems |
| FSTB | - Financial Services and the Treasury Bureau | RTGS | - Real Time Gross Settlement |
| F/CY | - Foreign currency | SEACEN | - South-East Asian Central Banks |
| G20 | - Group of Twenty | SFC | - Securities and Futures Commission |
| GBP | - Government Bond Programme | SFR | - Stable Funding Requirement |
| GDP | - Gross Domestic Product | SFO | - Securities and Futures Ordinance |
| GSC | - Governance Sub-Committee | SPM | - Supervisory Policy Manual |
| G-SIBs | - Global systemically important banks | SRP | - Supervisory review process |
| HIBOR | - Hong Kong Interbank Offered Rate | SVF | - Stored Value Facilities |
| HKAB | - Hong Kong Association of Banks | TMA | - Treasury Markets Association |
| HKDPB | - Hong Kong Deposit Protection Board | | |
| HKFRSs | - Hong Kong Financial Reporting Standards | | |
| HKIB | - Hong Kong Institute of Bankers | | |

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.

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