Consolidated Income Statement

for the year ended 31 December 2006

	Notes	2006 HK$'000	2005 HK$'000 Restated
Interest income	5	**2,294,607**	1,773,009
Interest expense	6	**(1,577,391)**	(1,111,458)
Net interest income		**717,216**	661,551
Other income, net	7	**154,410**	125,685
Operating income		**871,626**	787,236
Operating expenses	8	**(117,799)**	(115,937)
Operating profit before impairment		**753,827**	671,299
Write-back of loan impairment allowances	9	**8,473**	19,235
Profit before taxation		**762,300**	690,534
Taxation	10(a)	**(79,627)**	(89,272)
Profit for the year	12	**682,673**	601,262
Proposed dividend	13	**250,000**	250,000

The notes on pages 46 to 88 are an integral part of these consolidated financial statements.

Consolidated Balance Sheet

as at 31 December 2006

	Notes	2006 HK$'000	2005 HK$'000 Restated
ASSETS			
Cash and short-term funds	14	**1,914,806**	2,495,327
Interest and remittance receivables	15	**556,107**	389,828
Prepayments, deposits and other assets	16	**13,371**	15,657
Tax recoverable	10(b)	**–**	5,053
Derivative financial instruments	17	**262,760**	87,890
Loan portfolio, net	18	**32,394,092**	33,548,858
Investment securities:			
– available-for-sale	19(a)	**4,614,519**	1,989,973
– held-to-maturity	19(b)	**4,673,090**	4,524,894
Fixed assets	20	**19,356**	22,158
Reinsurance assets	23	**373,901**	429,178
		44,822,002	43,508,816
LIABILITIES			
Interest payable		**349,973**	257,933
Accounts payable, accrued expenses and other liabilities	22	**4,204,591**	4,365,341
Derivative financial instruments	17	**162,952**	344,730
Tax payable	10(b)	**16,511**	–
Deferred tax liabilities	10(b)	**27,810**	21,691
Insurance liabilities	23	**624,856**	684,212
Debt securities issued	24	**28,935,470**	27,995,867
Mortgage-backed securities issued	25	**5,361,260**	5,164,376
		39,683,423	38,834,150
SHAREHOLDERS' EQUITY			
Share capital	27	**2,000,000**	2,000,000
Retained profits		**2,678,722**	2,269,002
Contingency reserve	28	**84,678**	61,725
Fair value reserve	28	**125,179**	93,939
Proposed dividend	13	**250,000**	250,000
		5,138,579	4,674,666
		44,822,002	43,508,816

Approved and authorized for issue by the Board of Directors on 26 April 2007.

Yam Chi Kwong, Joseph
Deputy Chairman

Pang Sing Tong, Peter
Executive Director

The notes on pages 46 to 88 are an integral part of these consolidated financial statements.

Balance Sheet

as at 31 December 2006

	Notes	2006 HK$'000	2005 HK$'000
ASSETS			
Cash and short-term funds	14	**1,529,323**	2,474,338
Interest and remittance receivables	15	**535,112**	349,687
Prepayments, deposits and other assets	16	**43,824**	47,410
Tax recoverable	10(b)	**–**	4,994
Derivative financial instruments	17	**254,069**	85,266
Loan portfolio, net	18	**28,570,494**	29,417,710
Investment securities:			
– available-for-sale	19(a)	**4,614,519**	1,989,973
– held-to-maturity	19(b)	**4,673,090**	4,524,894
Investment in a subsidiary	21	**32,180**	60,960
Fixed assets	20	**19,356**	22,158
Reinsurance assets	23	**373,901**	429,178
		40,645,868	39,406,568
LIABILITIES			
Interest payable		**329,418**	237,103
Accounts payable, accrued expenses and other liabilities	22	**5,422,358**	5,480,687
Derivative financial instruments	17	**148,269**	308,915
Tax payable	10(b)	**16,511**	–
Deferred tax liabilities	10(b)	**28,019**	21,824
Insurance liabilities	23	**624,856**	684,212
Debt securities issued	24	**28,935,470**	27,995,867
		35,504,901	34,728,608
SHAREHOLDERS' EQUITY			
Share capital	27	**2,000,000**	2,000,000
Retained profits		**2,681,110**	2,272,296
Contingency reserve	28	**84,678**	61,725
Fair value reserve	28	**125,179**	93,939
Proposed dividend	13	**250,000**	250,000
		5,140,967	4,677,960
		40,645,868	39,406,568

Approved and authorized for issue by the Board of Directors on 26 April 2007.

Yam Chi Kwong, Joseph
Deputy Chairman

Pang Sing Tong, Peter
Executive Director

The notes on pages 46 to 88 are an integral part of these consolidated financial statements.

Consolidated Statement of Changes in Equity

for the year ended 31 December 2006

	Notes	Share capital HK$'000	Retained profits HK$'000	Other reserves HK$'000	Total HK$'000
Balance as at 1 January 2005, as previously reported		2,000,000	2,191,307	41,670	4,232,977
Effect of adopting HKAS 27 (revised)	2.1	–	(3,512)	–	(3,512)
Balance as at 1 January 2005, as restated		2,000,000	2,187,795	41,670	4,229,465
Fair value gains, net of tax					
– available-for-sale securities	28	–	–	93,939	93,939
Profit for the year, as restated	2.1	–	601,262	–	601,262
Transfer of 50% of net risk premium earned from retained profits to contingency reserve	2.18	–	(20,055)	20,055	–
Dividend paid relating to 2004		–	(250,000)	–	(250,000)
Balance as at 31 December 2005, as restated		2,000,000	2,519,002	155,664	4,674,666
Fair value gains, net of tax					
– available-for-sale securities	28	–	–	31,240	31,240
Profit for the year		–	682,673	–	682,673
Transfer of 50% of net risk premium earned from retained profits to contingency reserve	2.18	–	(22,953)	22,953	–
Dividend paid relating to 2005	13	–	(250,000)	–	(250,000)
Balance as at 31 December 2006		**2,000,000**	**2,928,722**	**209,857**	**5,138,579**

The notes on pages 46 to 88 are an integral part of these consolidated financial statements.

Consolidated Cash Flow Statement

for the year ended 31 December 2006

	Notes	2006 HK$'000	2005 HK$'000 Restated
Cash flows from operating activities			
Profit before taxation		**762,300**	690,534
Adjustment for:			
Depreciation		**10,594**	10,952
Loss on disposal of fixed assets		**2**	–
Amortisation of discount of debt securities		**42,116**	2,708
Write-back of loan impairment allowances		**(8,473)**	(19,235)
Loan portfolio written off net of recoveries		**(17,146)**	(58,595)
Amortisation of discount of investment securities		**(102,042)**	(10,086)
Net loss on disposal of available-for-sale securities		**–**	6,989
Change in fair value of financial instruments		**25,487**	14,461
		712,838	637,728
(Increase)/decrease in time deposits with more than three months' maturity		**(197,283)**	21,000
(Increase)/decrease in interest and remittance receivables		**(166,279)**	57,267
Decrease/(increase) in prepayments, deposits and other assets		**2,286**	(8,702)
Decrease in loan portfolio		**1,180,385**	7,254,321
Increase in interest payables		**92,040**	19,069
Decrease in accounts payable, accrued expenses and other liabilities		**(160,750)**	(280,727)
(Decrease)/increase in insurance liabilities, net		**(4,079)**	77,232
Exchange differences		**(17,413)**	9,490
Cash generated from operation		**1,441,745**	7,786,678
Hong Kong profits tax paid		**(58,570)**	(146,011)
Net cash generated from operating activities		**1,383,175**	7,640,667
Cash flows from investing activities			
Purchase of fixed assets	20	**(7,794)**	(9,658)
Purchase of available-for-sale securities	19(a)	**(21,051,103)**	(4,094,763)
Purchase of held-to-maturity securities	19(b)	**(357,028)**	(6,054,641)
Proceeds from sale and redemption of available-for-sale securities	19(a)	**18,602,056**	2,217,499
Proceeds from redemption of held-to-maturity securities	19(b)	**209,631**	5,617,764
Net cash used in investing activities		**(2,604,238)**	(2,323,799)
Net cash (outflows)/inflows before financing		**(1,221,063)**	5,316,868
Cash flows from financing activities			
Proceeds from issue of debt securities	24	**13,222,900**	5,095,964
Redemption of debt securities issued	24	**(12,699,326)**	(12,347,800)
Proceeds from issue of mortgage-backed securities	25	**2,000,000**	1,000,000
Repayment of mortgage-backed securities issued	25	**(1,830,315)**	(1,671,581)
Dividend paid		**(250,000)**	(250,000)
Net cash generated from/(used in) financing activities		**443,259**	(8,173,417)
Net decrease in cash and cash equivalents		**(777,804)**	(2,856,549)
Beginning cash and cash equivalents		**2,495,327**	5,351,876
Ending cash and cash equivalents	14	**1,717,523**	2,495,327

The notes on pages 46 to 88 are an integral part of these consolidated financial statements.

Notes to the Consolidated Financial Statements

1. Basis of Preparation

The consolidated financial statements of The Hong Kong Mortgage Corporation Limited (the "Company") and its subsidiaries (collectively the "Group") have been prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRSs" which is a collective term including all applicable individual Hong Kong Financial Reporting Standards ("HKFRS"), Hong Kong Accounting Standards ("HKFRSs" which is a collective term including all applicable individual Hong Kong Financial Reporting Standards ("HKFRS"), Hong Kong Accounting Standards ("HKASs") and Statements of Standard Accounting Practice and Interpretations) issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), accounting principles generally accepted in Hong Kong and the requirements of the Hong Kong Companies Ordinance.

The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale investment securities, financial assets and financial liabilities (including derivative financial instruments) at fair value through profit or loss.

The accounting policies and methods of computation used in the preparation of these consolidated financial statements are consistently applied to all the years presented, except that the Group has changed certain of its accounting policies following its adoption of new/revised HKFRSs which are effective for accounting periods commencing on or after 1 January 2006. The changes to the Group's accounting policies and the effect of adopting these new policies are set out in Note 2 below.

The preparation of financial statements in conformity with HKFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements, are disclosed in Note 4.

2. Significant Accounting Policies

2.1. Adoption of HKFRSs

In 2006, the Group adopted the new/revised HKFRSs below, which are relevant to its operations. The 2005 comparatives have been amended as required, in accordance with the relevant requirements.

- HKAS 19 (Amendment) Employee Benefits
  HKAS 19 (Amendment) is mandatory for the Group's accounting periods beginning on or after 1 January 2006. It introduces the option of an alternative recognition approach for actuarial gains and losses. It may impose additional recognition requirements for multi-employer plans where insufficient information is available to apply defined benefit accounting. It also adds new disclosure requirements. As the Group adopted defined contribution accounting and does not participate in any multi-employer plans, adoption of this amendment only impacts the format and extent of disclosures presented in the financial statements.

- HK(IFRIC) – Interpretation 4 Determining whether an Arrangement contains a Lease
  HK(IFRIC) – Interpretation 4 is mandatory for the Group's accounting periods beginning on or after 1 January 2006. This interpretation requires an assessment of whether certain supply arrangements contain in substance a lease that should be recognised by both the "lessor" and "lessee" in accordance with HKAS 17, Leases. The Group has reviewed its contracts in accordance with the requirements of this interpretation, and no additional contracts are accounted for as leases under HKAS 17.

- HKAS 27 (revised) Consolidated and Separate Financial Statements
  The adoption of the HKAS 27 (revised) has resulted in a change in accounting policy relating to the consolidation of the special purpose entities ("SPEs").

The Company uses two SPEs to securitise mortgage portfolios through the Guaranteed Mortgage-backed Pass-Through Securitisation Programme ("MBS Programme") and the US$3 Billion Mortgage-Backed Securitisation Programme ("Bauhinia MBS Programme").

The SPEs have not been consolidated under the previous HKAS 27 (revised) prior to 1 January 2006 as they were not construed as subsidiaries under the then Hong Kong Companies Ordinance. The Companies (Amendment) Ordinance 2005, effective for accounting periods beginning on or after 1 January 2006, has removed the legal constraint that prevented a Hong Kong incorporated company from consolidating in its Group's financial statements, the SPEs that are required to be consolidated under Hong Kong Financial Reporting Standards ("HKFRSs") but did not meet the legal definition of a subsidiary under the then Hong Kong Companies Ordinance, and HKAS 27 (revised) has been revised accordingly.

Under Section 2B(3) of the Hong Kong Companies Ordinance, as introduced by the Companies (Amendment) Ordinance 2005, which comes into effect for the periods beginning 1 January 2006, the two SPEs would be deemed to be subsidiary undertakings of the Company for the purposes of preparing group accounts. Therefore, the financial statements of the two SPEs have been consolidated in the Group's financial statements starting from 1 January 2006. Retrospective application to prior year comparatives have been made in accordance with HKAS 27 (revised). The adjustments required for the adoption of HKAS 27 (revised) resulted in decrease in shareholders' equity as at 31 December 2004 and 2005 of HK$3.5 million and HK$2.9 million respectively and an increase in net profit for the year ended 31 December 2005 by HK$0.6 million. The tables below disclose the effect of changes that have been made in accordance with the HKAS 27 (revised) to each of the balance sheet and income statement items.

Estimated effect of adoption of HKAS 27 (revised) on consolidated balance sheet items

The Group	2006 HK$'000	2005 HK$'000
Increase/(decrease) in assets as at 31 December		
Cash and short-term funds	**383,832**	18,795
Interest and remittance receivables	**20,822**	39,906
Prepayments, deposits and other assets	**(30,453)**	(31,753)
Tax recoverable	**–**	(3)
Derivative financial instruments	**8,691**	2,624
Loan portfolio, net	**3,794,224**	4,073,196
	4,177,116	4,102,765
(Increase)/decrease in liabilities as at 31 December		
Interest payable	**(20,555)**	(20,830)
Accounts payable, accrued expenses and other liabilities	**1,217,795**	1,115,375
Derivative financial instruments	**(14,683)**	(35,815)
Mortgage-backed securities issued	**(5,361,260)**	(5,164,376)
	(4,178,703)	(4,105,646)
Decrease in shareholders' equity as at 31 December		
Retained profits	**(1,587)**	(2,881)

Estimated effect of adoption of HKAS 27 (revised) on consolidated income statement for the year ended 31 December 2006 and 2005

	2006 **HK$'000**	2005 HK$'000
Increase/(decrease) in profit for the year		
Net interest income	**42,945**	40,918
Other income	**(42,425)**	(39,576)
Operating expenses	**(479)**	(1,305)
Write-back of impairment allowances	**1,249**	596
Taxation credit/(charge)	**4**	(2)
	1,294	631

The HKICPA has issued a number of new and revised HKFRSs which are effective for accounting periods beginning or after 1 January 2007. The Group has not early adopted the following new Standard, Amendment and Interpretation which are relevant to its operation:

HKAS 1 (Amendment)	Presentation of financial statements: Capital Disclosures
HKFRS 7	Financial Instruments: Disclosures
HK(IFRIC) Interpretation 9	Reassessment of Embedded Derivatives

The Group has assessed the impact of HKFRS 7 and the amendment to HKAS 1 and concluded that the key impact will be more qualitative and quantitative disclosures primarily related to fair value measurement and risk management. Accordingly the adoption of these standards will have no effect on the Group's results of operations or financial position. The Group will apply HKFRS 7 and the amendment to HKAS 1 from annual periods beginning 1 January 2007.

The Group has assessed whether embedded derivatives are required to be separated from the host contracts and accounted for as derivatives when the entity first becomes a party to the contract. Subsequent reassessment is prohibited. The Group will apply HK(IFRIC) – INT 9 from 1 January 2007, but it is not expected to have any material impact on the Group's financial statements.

2.2. Consolidation

The consolidated financial statements include the financial statements of the Company and its subsidiaries made up to 31 December.

Subsidiaries are all entities (including special purpose entities) over which the Group has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date that control ceases.

Inter-company transactions, balances and unrealised gains on transactions between group companies are eliminated. Unrealised losses are also eliminated unless the transaction provides evidence of impairment of the asset transferred. Accounting policies of the subsidiary have been changed where necessary to ensure consistency with the policies adopted by the Group.

In the Company's balance sheet, the investment in the subsidiary is stated at cost less provision for impairment allowances. The results of the subsidiary are accounted for by the Company on the basis of dividends received and receivable.

2.3. Interest Income and Expense

Interest income and expense are recognised in the income statement for all instruments measured at amortised cost using the effective interest method.

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 and points 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.

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 recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

2.4. Fee and Commission Income

Fees and commissions are generally recognised on an accrual basis when the service has been provided. Upfront arrangement fees that are an integral part of the effective interest rate are recognised as an adjustment to the effective interest rate on the loans.

2.5. Financial Assets

The Group classifies its financial assets in the following categories: financial assets at fair value through profit or loss; loans and receivables; held-to-maturity investments; and available-for-sale financial assets. The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition and re-evaluates this designation at every reporting date.

(a) Financial assets at fair value through profit or loss

This category has two sub-categories: financial assets held for trading, and those designated as at fair value through profit or loss at inception. A financial asset is classified as held for trading if acquired principally for the purpose of selling in the short term or if it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of recent actual pattern of short-term profit-making. Derivatives are also categorised as held for trading unless they are designated as hedges.

A financial asset is typically classified as fair value through profit or loss at inception if it meets the following criteria:

(i) the designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as "an accounting mismatch") that would otherwise arise from measuring the financial assets or financial liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets and/or financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and this is the basis on which information about the financial assets and/or financial liabilities is provided internally to the key management personnel.

(b) 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 for which the Group has no intention of trading the loan and receivable.

(c) Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity. If the Group was to sell other than an insignificant amount of held-to-maturity assets, the entire category would be tainted and reclassified as available-for-sale.

(d) Available-for-sale

Available-for-sale investments are non-derivative financial investments that are either designated in this category or not classified in any of the other categories. Available-for-sale investments are those intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rate, exchange rate or market prices. They are initially recognised at fair value including direct and incremental transaction costs. They are subsequently held at fair value.

Purchases and sales of financial assets are recognised on settlement date. Financial assets are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss. Financial assets carried at fair value through profit or loss are initially recognised at fair value, and transaction costs are expensed in the income statement. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Loans and receivables and held-to-maturity investments are carried at amortised cost using the effective interest method. Gains and losses arising from changes in the fair value of the "financial assets at fair value through profit or loss" category are included in the income statement in the period in which they arise. Unrealised gains and losses arising from changes in the fair value of available-for-sale financial assets are recognised directly in equity, until the financial asset is derecognised or impaired at which time the cumulative gain or loss previously recognised in equity should be recognised in income statement. However, interest calculated using the effective interest method is recognised in the income statement. Dividends on available-for-sale equity instruments are recognised in the income statement when the entity's right to receive payment is established.

Changes in the fair value of monetary securities denominated in a foreign currency and classified as available-for-sale are analysed between translation differences resulting from changes in amortised cost of the securities and other changes in the carrying amount of the securities. The translation differences on monetary securities are recognised in income statement; translation differences on non-monetary securities are recognised in equity. Changes in the fair value of monetary and non-monetary securities classified as available-for-sale are recognised in equity.

The fair value of quoted investments in active markets are based on current bid prices. If the market for a financial asset is not active, the Group establishes fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis and other valuation techniques commonly used by market participants.

2.6. Impairment of Financial Assets

(a) Assets carried at amortised cost

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the Group about the following loss events:

- significant financial difficulty of the issuer or obligor;
- a breach of contract, such as a default or delinquency in interest or principal payments;
- the Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a concession that the Group would not otherwise consider;

- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
  - adverse changes in the payment status of borrowers in the group; or
  - economic conditions that correlate with defaults on the assets in the group.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not 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 the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement. If a loan or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract. As a practical expedient, the Group may measure impairment on the basis of an instrument's fair value using an observable market price.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics which are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the Group and historical loss experience for assets with credit risk characteristics similar to those in the Group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

Estimates of changes in future cash flows for groups of assets should reflect and be directionally consistent with changes in related observable data from period to period which are indicative of changes in the probability of losses in the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

When a loan is uncollectable, it is written off against the related allowance for loan impairment at the discretion of the Credit Committee. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the allowance for loan impairment in the income statement.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement.

(b) Assets carried at fair value

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the income statement.

2.7. Financial Liabilities

Financial liabilities are classified into two categories: financial liabilities at fair value through profit or loss and other financial liabilities. All the financial liabilities are classified at inception and recognised initially at fair value.

The notes issued under the Note Issuance Programme ("NIP"), the notes and Transferable Loan Certificates ("TLC") issued under the Debt Issuance Programme ("DIP") and the notes offered to retail investors through the placing banks in standalone retail bond issues and under the Retail Bond Issuance Programme ("RBIP") are recorded as debt securities issued on the balance sheet. The Mortgage-Backed Securities ("MBS") issued by the SPEs through the MBS Programme and Bauhinia MBS Programme are recorded as mortgage-backed securities issued in the balance sheet on consolidation of the SPEs. These notes (including MBS) are initially designated as financial liabilities (i) at fair value through profit or loss or (ii) other financial liabilities.

The notes (including those issued with embedded derivative instruments) designated as hedged items under a fair value hedge and at fair value through profit or loss upon initial recognition are carried at fair value, with changes in fair value being recorded in the income statement.

The notes designated as other financial liabilities are measured at cost, which is the fair value of the consideration received, net of transaction costs incurred. The notes are subsequently stated at amortised costs; any difference between proceeds net of transaction costs and the redemption value is recognised in the income statement over the period of the debt securities using the effective interest method.

On redemption/repurchase of the notes, the resulting gains or losses, being the difference between the redemption/repurchase amount and the carrying amount, are recognised in the income statement in the period in which the redemption/repurchase takes place.

2.8. Derivative Financial Instruments and Hedge Accounting

Derivatives are initially recognised at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and valuation techniques, including discounted cash flow models and options pricing models, as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

The best evidence of the fair value of a derivative at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group recognises profits on day 1.

Certain derivatives embedded in other financial instruments are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

The method of recognising the resulting fair value gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged. The Group designates certain derivatives as either: (1) hedges of the fair value of recognised assets or liabilities or firm commitments (fair value hedge); or, (2) hedges of highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction (cash flow hedge). Hedge accounting is used for derivatives designated in this way provided certain criteria are met.

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.

(a) Fair value hedge

Changes in the fair value of derivatives that are designated and qualified as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used, is amortised to profit or loss over the period to maturity.

(b) Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualified as cash flow hedges are recognised in equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, 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 statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

(c) Derivatives at fair value through profit or loss

Derivative instruments entered into as economic hedges that do not qualify for hedge accounting are held at fair value through profit or loss. Changes in the fair value of any derivative instrument are recognised immediately in the income statement.

2.9. Offsetting Financial Instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when 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 asset and settle the liability simultaneously.

2.10. Foreign Currency Translation

(a) Functional and presentation currency

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated financial statements are presented in Hong Kong dollars, which is the Company's functional and presentation currency.

(b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as qualifying cash flow hedges.

Translation differences on non-monetary items held at fair value through profit or loss are reported as part of the fair value gain or loss. Translation differences on non-monetary items classified as available-for-sale financial assets, are included in the fair value reserve in equity.

2.11. Fixed Assets

Fixed assets are stated at historical cost less accumulated depreciation and impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognised. All other repairs and maintenance are charged to the income statement during the financial period in which they are incurred.

Depreciation is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives.

Leasehold improvement	over the unexpired period of the lease
Furniture and fixtures	over the unexpired period of the lease
Computer	3 years
Office equipment	3 years
Motor vehicle	4 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Gain and loss on disposal is determined by comparing proceeds with carrying amount. It is included in the income statement.

2.12. Impairment of Investment in Subsidiaries and Non-financial Assets

Assets that have an indefinite useful life or are not yet available for use are not subject to amortisation, but are tested annually for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. The recoverable amount is the higher of the asset's fair value less costs to sell and value in use.

2.13. Deferred Income Tax

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Deferred income tax is provided on temporary differences arising from investment in the subsidiary, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future.

Income tax payable on profits is recognised as an expense in the period in which profits arise. The tax effects of income tax losses available for carry-forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised.

Deferred tax related to fair value re-measurement of available-for-sale investments and cash flow hedges, which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement together with the deferred gain or loss.

2.14. Employee Benefits

(a) Employee leave entitlements

Employee entitlements to annual leave and long-service leave are recognised when they accrue to employees. An accrual is made for the estimated liability for annual leave and long-service leave as a result of services rendered by employees up to the balance sheet date.

Employee entitlements to sick leave, maternity or paternity leave are recognised when the absence occurs.

(b) Bonus plans

The Company recognises a liability and an expense for bonuses, based on a formula that takes into consideration the profit after certain adjustments. The Company recognises a provision where contractually obliged or where there is a past practice that has created constructive obligations.

(c) Pension obligations

The Company offers a mandatory provident fund scheme and a defined contribution scheme, the assets of which are generally held in separate trustee – administered funds. These pension plans are generally funded by payments from employees and by the Company.

The Company's contributions to the mandatory provident fund scheme and defined contribution scheme are expensed as incurred and are reduced by the portion of employer contributions being forfeited by those employees who leave the scheme prior to full vesting of the employer contributions.

(d) Termination benefits

Termination benefits are payable when employment is terminated before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Company recognises termination benefits when it is demonstrably committed to either: terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal; or providing termination benefits as a result of an offer made to encourage voluntary redundancy. Benefits falling due more than 12 months after the balance sheet date are discounted to present value.

2.15. Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events where it is more likely than not that an outflow of resources will be required to settle the obligation, and the amount has been reliably estimated.

Provisions are measured at the present value of the expenditure expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation.

2.16. Leases

(a) Operating leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. The Group entered into operating leases primarily as lessee. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

(b) Finance leases

Leases of assets where the Group has substantially all the risks and rewards of ownership are classified as finance leases. The Group entered into finance leases primarily as lessor. Finance leases are capitalised at the lease's commencement at the lower of the fair value of the leased property and the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. When assets are leased out under a finance lease, the present value of the lease payments is recognised as a receivable. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance income. Lease income is recognised over the term of the lease using the net investment method, which reflects a constant periodic rate of return. Hire purchase contracts having the characteristics of a finance lease are accounted for in the same manner as finance leases. Impairment allowances are accounted for in accordance with the accounting policies set out in Note 2.6.

2.17. Cash and Cash Equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, including cash, balances with banks and other financial institutions.

2.18. Mortgage Insurance Contracts

The mortgage insurance business of the Group is accounted for on the annual accounting basis. Under the annual accounting approach, the Group makes provisions based on credible estimates of future income and outgoings to determine the underwriting result for the current accounting period. The underwriting result includes any adjustments arising from the correction of the previous estimates.

Gross premiums represent direct business written through the Authorized Institutions during an accounting period. The gross premiums after deduction of discounts, include the reinsurance premiums to be paid to the approved reinsurers, the risk premiums and servicing fees earned by the Group. The net premiums are recognised as income on a time-apportioned basis during the time the insurance coverage is effective.

Unearned premiums represent that portion of net premiums written which are estimated to relate to risks and services subsequent to the balance sheet date.

Provisions are made for outstanding claims, claims incurred but not reported and loss reserve at the end of each period. For risk-sharing business, 50% of the net risk premiums earned is set aside as a Contingency Reserve for a reasonable period of time in accordance with relevant regulatory guidelines and as considered by directors to be appropriate.

Reinsurance contracts refer to contracts entered into by the Group with reinsurers under which the Group is compensated for losses on one or more insurance contracts issued by the Group. Benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of claims recoverable from reinsurers and receivables that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured insurance contracts and in accordance with the terms of each reinsurance contract. Reinsurance liabilities are primarily premiums payable for reinsurance contracts and are recognised as an expense when due.

2.19. Financial Guarantee Contracts

Financial guarantee contracts are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Financial guarantees are given to investors of mortgage-backed securities issued.

Financial guarantees are initially recognised in the financial statements at fair value on the date that the guarantee was given. Subsequent to initial recognition, the Group's liabilities under such guarantees are measured at the higher of the amount determined in accordance with HKAS 37 Provisions, Contingent Liabilities and Contingent Assets and the amount initially recognised less cumulative amortisation recognised. Any changes in the liability relating to financial guarantees are taken to the income statement.

2.20. Dividend

Dividend proposed or declared after the balance sheet date is disclosed as a separate component of shareholders' equity.

3. Risk Management

3.1. Strategy in Using Financial Instruments

The principal activities of the Group are (i) to purchase portfolios of mortgages or loans whether unsecured or secured on properties or other collateral situated in Hong Kong or elsewhere, rights, interests and benefits under hire purchase or leasing arrangements made in respect of motor vehicles and other assets, and debentures, receivables, financial assets and choses in action of all kinds from their originators, issuers, owners or vendors; (ii) to raise financing for its purchase of assets through issuance of debt securities; (iii) to securitise mortgage portfolios through special purpose entities by way of issuing mortgage-backed securities ("MBS"); and (iv) to provide mortgage insurance cover to Authorized Institutions in respect of mortgage loans originated by such Authorized Institutions and secured by residential properties in Hong Kong.

By their nature, the Group's activities are principally related to the use of financial instruments including cash, loans, debts and derivatives. The Group hedges a major proportion of its existing interest rate risk of the fixed-rate bond issuance by fair value hedges in the form of interest rate swaps by swapping into floating-rate funding to better match the floating-rate assets. The net fair value gain of such interest rate swaps designated as fair value hedges as at 31 December 2006 was HK$124,362,000 (Note 17 (b)).

3.2. Credit Risk

The Group's principal financial assets are its loan portfolio, investment securities, cash and short-term funds. The credit risk on liquid funds and investment securities is limited because the counterparties are mainly sovereigns, quasi-sovereign agencies, banks and companies with very high credit ratings.

The Group's credit risk is primarily attributable to its loan portfolio, which is the risk that a loan borrower will be unable to pay amounts in full when due. Allowance for impairment is provided for losses that have been incurred at the balance sheet date.

Significant changes in the economy and local property market could result in losses that are different from those provided for at the balance sheet date. The Group therefore has a prudent policy for managing its exposure to credit risk.

To maintain the quality of the asset and mortgage insurance portfolios, the Group adheres to a four-pronged approach to (i) select Approved Sellers carefully, (ii) adopt prudent asset purchasing criteria and insurance eligibility criteria,

(iii) conduct effective due diligence review and (iv) ensure adequate protection for higher-risk assets or transactions. The Group has no significant concentration of credit risk. Risk exposure is spread over a large number of customers, counterparties and a diversified geographic distribution of underlying collateral in Hong Kong.

For financial instruments such as derivatives, exposures are monitored against counterparty risk limits established in accordance with the investment guidelines and credit risk policy of the Group. These counterparty risk limits are subject to regular review by the Credit Committee on a semi-annual basis. At any one time, the amount subject to credit risk is limited to the current fair value of instruments that are favourable to the Group (i.e. assets where their fair value is positive), which in relation to derivatives is only a small fraction of the contract, or notional values used to express the volume of instruments outstanding. This credit risk exposure is managed as part of the overall credit limits with counterparties, together with potential exposures from market movements.

3.3. Currency Risk

The Group takes on exposure to effects of fluctuations in the prevailing foreign currency exchange rate on its financial position and cash flows. The Board sets allowable currencies for investment. Currently, the Group's foreign currency exposure is limited to US dollar only. The Asset and Liability Committee ("ALCO") sets limits on the currency exposure that may be undertaken, which is monitored daily.

The tables below summarise the Group's exposure to foreign currency exchange rate risk. Included in the tables are the Group's assets and liabilities at carrying amounts, categorised by currency.

The Group	HK$ HK$'000	US$ HK$'000	Total HK$'000
As at 31 December 2006			
Assets			
Cash and short-term funds	1,069,268	845,538	1,914,806
Interest and remittance receivables	493,901	62,206	556,107
Prepayments, deposits and other assets	13,371	–	13,371
Derivative financial instruments	234,711	28,049	262,760
Loan portfolio, net	32,394,092	–	32,394,092
Investment securities:			
– available-for-sale	793,444	3,821,075	4,614,519
– held-to-maturity	2,261,866	2,411,224	4,673,090
Fixed assets	19,356	–	19,356
Reinsurance assets	373,901	–	373,901
Total assets	37,653,910	7,168,092	44,822,002
Liabilities			
Interest payable	343,059	6,914	349,973
Accounts payable, accrued expenses and other liabilities	4,204,591	–	4,204,591
Derivative financial instruments	117,968	44,984	162,952
Tax payable	16,511	–	16,511
Deferred tax liabilities	27,810	–	27,810
Insurance liabilities	624,856	–	624,856
Debt securities issued	28,454,325	481,145	28,935,470
Mortgage-backed securities issued	5,361,260	–	5,361,260
Total liabilities	39,150,380	533,043	39,683,423
Net position	(1,496,470)	6,635,049	5,138,579
Off-balance sheet net notional position#	5,419,876	(5,419,883)	(7)

Off-balance sheet net notional position represents the difference between the notional amounts of foreign currency derivative financial instruments, which are principally used to reduce the Group's exposure to currency movements, and their fair values.

The Company	HK$ HK$'000	US$ HK$'000	Total HK$'000
As at 31 December 2006			
Assets			
Cash and short-term funds	683,785	845,538	1,529,323
Interest and remittance receivables	472,906	62,206	535,112
Prepayments, deposits and other assets	43,824	–	43,824
Derivative financial instruments	226,020	28,049	254,069
Loan portfolio, net	28,570,494	–	28,570,494
Investment securities:			
– available-for-sale	793,444	3,821,075	4,614,519
– held-to-maturity	2,261,866	2,411,224	4,673,090
Investment in a subsidiary	32,180	–	32,180
Fixed assets	19,356	–	19,356
Reinsurance assets	373,901	–	373,901
Total assets	33,477,776	7,168,092	40,645,868
Liabilities			
Interest payable	322,504	6,914	329,418
Accounts payable, accrued expenses and other liabilities	5,422,358	–	5,422,358
Derivative financial instruments	103,285	44,984	148,269
Tax payable	16,511	–	16,511
Deferred tax liabilities	28,019	–	28,019
Insurance liabilities	624,856	–	624,856
Debt securities issued	28,454,325	481,145	28,935,470
Total liabilities	34,971,858	533,043	35,504,901
Net position	(1,494,082)	6,635,049	5,140,967
Off-balance sheet net notional position#	5,419,876	(5,419,883)	(7)

Off-balance sheet net notional position represents the difference between the notional amounts of foreign currency derivative financial instruments, which are principally used to reduce the Company's exposure to currency movements, and their fair values.

The Group	HK$ HK$'000	US$ HK$'000	Total HK$'000
As at 31 December 2005 (restated)			
Assets			
Cash and short-term funds	1,376,726	1,118,601	2,495,327
Interest and remittance receivables	350,952	38,876	389,828
Prepayments, deposits and other assets	15,657	–	15,657
Tax recoverable	5,053	–	5,053
Derivative financial instruments	87,890	–	87,890
Loan portfolio, net	33,548,858	–	33,548,858
Investment securities:			
– available-for-sale	596,461	1,393,512	1,989,973
– held-to-maturity	2,114,492	2,410,402	4,524,894
Fixed assets	22,158	–	22,158
Reinsurance assets	429,178	–	429,178
Total assets	38,547,425	4,961,391	43,508,816
Liabilities			
Interest payable	256,077	1,856	257,933
Accounts payable, accrued expenses and other liabilities	4,365,341	–	4,365,341
Derivative financial instruments	344,730	–	344,730
Deferred tax liabilities	21,691	–	21,691
Insurance liabilities	684,212	–	684,212
Debt securities issued	27,854,985	140,882	27,995,867
Mortgage-backed securities issued	5,164,376	–	5,164,376
Total liabilities	38,691,412	142,738	38,834,150
Net position	(143,987)	4,818,653	4,674,666
Off-balance sheet net notional position#	141,363	(140,882)	481

Off-balance sheet net notional position represents the difference between the notional amounts of foreign currency derivative financial instruments, which are principally used to reduce the Group's exposure to currency movements, and their fair values.

The Company	HK$ HK$'000	US$ HK$'000	Total HK$'000
As at 31 December 2005			
Assets			
Cash and short-term funds	1,355,737	1,118,601	2,474,338
Interest and remittance receivables	310,811	38,876	349,687
Prepayments, deposits and other assets	47,410	–	47,410
Tax recoverable	4,994	–	4,994
Derivative financial instruments	85,266	–	85,266
Loan portfolio, net	29,417,710	–	29,417,710
Investment securities:			
– available-for-sale	596,461	1,393,512	1,989,973
– held-to-maturity	2,114,492	2,410,402	4,524,894
Investment in a subsidiary	60,960	–	60,960
Fixed assets	22,158	–	22,158
Reinsurance assets	429,178	–	429,178
Total assets	34,445,177	4,961,391	39,406,568
Liabilities			
Interest payable	235,247	1,856	237,103
Accounts payable, accrued expenses and other liabilities	5,480,687	–	5,480,687
Derivative financial instruments	308,915	–	308,915
Deferred tax liabilities	21,824	–	21,824
Insurance liabilities	684,212	–	684,212
Debt securities issued	27,854,985	140,882	27,995,867
Total liabilities	34,585,870	142,738	34,728,608
Net position	(140,693)	4,818,653	4,677,960
Off-balance sheet net notional position#	141,363	(140,882)	481

Off-balance sheet net notional position represents the difference between the notional amounts of foreign currency derivative financial instruments, which are principally used to reduce the Company's exposure to currency movements, and their fair values.

3.4. Cash Flow and Fair Value Interest Rate Risk

Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates. The Group takes on exposure to the effects of fluctuations in the prevailing levels of market interest rates on both its fair value and cash flow risks. Interest margins may increase as a result of such changes but may reduce or create losses in the event that unexpected movements arise. The ALCO sets limits on the level of interest rate mismatch that may be undertaken, which is monitored regularly.

The Group makes prudent use of a range of financial instruments such as interest rate swaps, basis swaps, forward rate agreements and the issuance of MBS to manage the interest rate mismatch risk. The proceeds of the fixed-rate debt securities are generally swapped into HIBOR-based funds via interest rate swaps. Through the use of such swaps, interest expenses will be changed from a fixed-rate basis to a floating-rate basis in order to better match the floating-rate income from the mortgage assets.

The tables below summarise the Group's exposure to interest rate risks. Included in the tables are the Group's assets and liabilities at carrying amounts, categorised by the earlier of contractual repricing or maturity dates. The carrying amounts of derivative financial instruments, which are principally used to reduce the Group's exposure to interest rate movements, are included under the heading "Non-interest bearing".

Expected repricing and maturity dates do not differ significantly from the contract dates.

The Group	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Non-interest bearing HK$'000	Total HK$'000
As at 31 December 2006							
Assets							
Cash and short-term funds	1,562,244	110,245	197,283	–	–	45,034	1,914,806
Interest and remittance receivables	–	–	–	–	–	556,107	556,107
Prepayments, deposits and other assets	–	–	–	–	–	13,371	13,371
Derivative financial instruments	–	–	–	–	–	262,760	262,760
Loan portfolio, net	28,237,191	4,049,776	68,894	36,347	1,884	–	32,394,092
Investment securities:							
– available-for-sale	2,475,848	455,640	140,602	763,489	236,931	542,009	4,614,519
– held-to-maturity	241,768	370,086	641,668	2,256,445	1,163,123	–	4,673,090
Fixed assets	–	–	–	–	–	19,356	19,356
Reinsurance assets	–	–	–	–	–	373,901	373,901
Total assets	32,517,051	4,985,747	1,048,447	3,056,281	1,401,938	1,812,538	44,822,002
Liabilities							
Interest payable	–	–	–	–	–	349,973	349,973
Accounts payable, accrued expenses and other liabilities	4,120,474	–	–	–	–	84,117	4,204,591
Derivative financial instruments	–	–	–	–	–	162,952	162,952
Tax payable	–	–	–	–	–	16,511	16,511
Deferred tax liabilities	–	–	–	–	–	27,810	27,810
Insurance liabilities	–	–	–	–	–	624,856	624,856
Debt securities issued	2,798,933	5,789,542	4,942,558	13,045,490	2,358,947	–	28,935,470
Mortgage-backed securities issued	2,127,252	–	696,315	2,537,693	–	–	5,361,260
Total liabilities	9,046,659	5,789,542	5,638,873	15,583,183	2,358,947	1,266,219	39,683,423
Total interest sensitivity gap*	23,470,392	(803,795)	(4,590,426)	(12,526,902)	(957,009)		

* before the repricing effect of derivative financial instruments on the debt securities and the mortgage-backed securities issued.

The Company	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Non-interest bearing HK$'000	Total HK$'000
As at 31 December 2006							
Assets							
Cash and short-term funds	1,485,284	–	–	–	–	44,039	1,529,323
Interest and remittance receivables	–	–	–	–	–	535,112	535,112
Prepayments, deposits and other assets	–	–	–	–	–	43,824	43,824
Derivative financial instruments	–	–	–	–	–	254,069	254,069
Loan portfolio, net	24,425,408	4,047,262	67,738	30,086	–	–	28,570,494
Investment securities:							
– available-for-sale	2,475,848	455,640	140,602	763,489	236,931	542,009	4,614,519
– held-to-maturity	241,768	370,086	641,668	2,256,445	1,163,123	–	4,673,090
Investment in a subsidiary	21,307	–	1,227	6,646	2,000	1,000	32,180
Fixed assets	–	–	–	–	–	19,356	19,356
Reinsurance assets	–	–	–	–	–	373,901	373,901
Total assets	28,649,615	4,872,988	851,235	3,056,666	1,402,054	1,813,310	40,645,868
Liabilities							
Interest payable	–	–	–	–	–	329,418	329,418
Accounts payable, accrued expenses and other liabilities	5,202,563	–	–	–	–	219,795	5,422,358
Derivative financial instruments	–	–	–	–	–	148,269	148,269
Tax payable	–	–	–	–	–	16,511	16,511
Deferred tax liabilities	–	–	–	–	–	28,019	28,019
Insurance liabilities	–	–	–	–	–	624,856	624,856
Debt securities issued	2,798,933	5,789,542	4,942,558	13,045,490	2,358,947	–	28,935,470
Total liabilities	8,001,496	5,789,542	4,942,558	13,045,490	2,358,947	1,366,868	35,504,901
Total interest sensitivity gap*	20,648,119	(916,554)	(4,091,323)	(9,988,824)	(956,893)		

* before the repricing effect of derivative financial instruments on the debt securities issued.

The Group	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Non-interest bearing HK$'000	Total HK$'000
As at 31 December 2005 (restated)							
Assets							
Cash and short-term funds	2,465,294	6,800	–	–	–	23,233	2,495,327
Interest and remittance receivables	–	–	–	–	–	389,828	389,828
Prepayments, deposits and other assets	–	–	–	–	–	15,657	15,657
Tax recoverable	–	–	–	–	–	5,053	5,053
Derivative financial instruments	–	–	–	–	–	87,890	87,890
Loan portfolio, net	33,165,505	230,116	81,284	71,953	–	–	33,548,858
Investment securities:							
– available-for-sale	851,092	728,377	–	–	–	410,504	1,989,973
– held-to-maturity	–	675,273	506,000	2,182,126	1,161,495	–	4,524,894
Fixed assets	–	–	–	–	–	22,158	22,158
Reinsurance assets	–	–	–	–	–	429,178	429,178
Total assets	36,481,891	1,640,566	587,284	2,254,079	1,161,495	1,383,501	43,508,816
Liabilities							
Interest payable	–	–	–	–	–	257,933	257,933
Accounts payable, accrued expenses and other liabilities	4,278,202	–	–	–	–	87,139	4,365,341
Derivative financial instruments	–	–	–	–	–	344,730	344,730
Deferred tax liabilities	–	–	–	–	–	21,691	21,691
Insurance liabilities	–	–	–	–	–	684,212	684,212
Debt securities issued	2,779,677	3,806,397	9,297,010	7,752,058	4,360,725	–	27,995,867
Mortgage-backed securities issued	3,697,567	–	–	1,466,809	–	–	5,164,376
Total liabilities	10,755,446	3,806,397	9,297,010	9,218,867	4,360,725	1,395,705	38,834,150
Total interest sensitivity gap*	25,726,445	(2,165,831)	(8,709,726)	(6,964,788)	(3,199,230)		

* before the repricing effect of derivative financial instruments on the debt securities and the mortgage-backed securities issued.

The Company	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Non-interest bearing HK$'000	Total HK$'000
As at 31 December 2005							
Assets							
Cash and short-term funds	2,445,917	6,800	–	–	–	21,621	2,474,338
Interest and remittance receivables	–	–	–	–	–	349,687	349,687
Prepayments, deposits and other assets	–	–	–	–	–	47,410	47,410
Tax recoverable	–	–	–	–	–	4,994	4,994
Derivative financial instruments	–	–	–	–	–	85,266	85,266
Loan portfolio, net	29,079,967	210,902	54,888	71,953	–	–	29,417,710
Investment securities:							
– available-for-sale	851,092	728,377	–	–	–	410,504	1,989,973
– held-to-maturity	–	675,273	506,000	2,182,126	1,161,495	–	4,524,894
Investment in a subsidiary	26,292	6,357	27,311	–	–	1,000	60,960
Fixed assets	–	–	–	–	–	22,158	22,158
Reinsurance assets	–	–	–	–	–	429,178	429,178
Total assets	32,403,268	1,627,709	588,199	2,254,079	1,161,495	1,371,818	39,406,568
Liabilities							
Interest payable	–	–	–	–	–	237,103	237,103
Accounts payable, accrued expenses and other liabilities	5,254,078	–	–	–	–	226,609	5,480,687
Derivative financial instruments	–	–	–	–	–	308,915	308,915
Deferred tax liabilities	–	–	–	–	–	21,824	21,824
Insurance liabilities	–	–	–	–	–	684,212	684,212
Debt securities issued	2,779,677	3,806,397	9,297,010	7,752,058	4,360,725	–	27,995,867
Total liabilities	8,033,755	3,806,397	9,297,010	7,752,058	4,360,725	1,478,663	34,728,608
Total interest sensitivity gap*	24,369,513	(2,178,688)	(8,708,811)	(5,497,979)	(3,199,230)		

* before the repricing effect of derivative financial instruments on the debt securities issued.

The table below summarises the effective interest rate* by major currencies for major monetary financial instruments of the Group not carried at fair value through profit or loss:

	As at 31 December 2006		As at 31 December 2005	
	HK$ %	**US$ %**	HK$ % Restated	US$ %
Assets				
Cash and short-term funds	**4.00%**	**5.31%**	4.05%	4.38%
Loan portfolio	**5.20%**	**–**	5.48%	–
Investment securities	**4.21%**	**5.23%**	4.20%	4.61%
Liabilities				
Other liabilities	**3.90%**	**–**	4.23%	–
Debt securities issued	**4.18%**	**5.00%**	4.23%	3.10%
Mortgage-backed securities issued	**4.11%**	**–**	4.12%	–

* before the repricing effect of derivative financial instruments on the debt securities and the mortgage-backed securities issued.

3.5. Liquidity Risk

Liquidity risk represents the risk of the Group not being able to repay its obligations or to fund committed purchases of mortgage loans. Liquidity risk is managed by monitoring the actual inflow and outflow of funds on a daily basis and projecting longer-term inflows and outflows of funds across a full maturity spectrum. The Group has established diversified funding sources to support the growth of its business and the maintenance of a balanced portfolio of liabilities. The table below analyses the Group's major assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date.

The Group	Repayable on demand HK$'000	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Undated HK$'000	Total HK$'000
As at 31 December 2006								
Assets								
Cash and short-term funds	47,081	1,560,197	110,245	197,283	–	–	–	1,914,806
Loan portfolio	15,074	599,507	388,961	2,622,862	16,906,126	11,819,544	72,246	32,424,320
Investment securities								
– available-for-sale	–	2,679,490	–	140,602	1,015,487	236,931	542,009	4,614,519
– held-to-maturity	–	241,768	357,940	641,668	2,268,591	1,163,123	–	4,673,090
	62,155	5,080,962	857,146	3,602,415	20,190,204	13,219,598	614,255	43,626,735
Liabilities								
Debt securities issued	–	949,054	5,190,505	6,641,483	13,795,482	2,358,946	–	28,935,470
Mortgage-backed securities issued	40	39,738	34,052	768,930	2,852,654	1,665,846	–	5,361,260
	40	988,792	5,224,557	7,410,413	16,648,136	4,024,792	–	34,296,730

The Company	Repayable on demand HK$'000	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Undated HK$'000	Total HK$'000
As at 31 December 2006								
Assets								
Cash and short-term funds	45,430	1,483,893	–	–	–	–	–	1,529,323
Loan portfolio	9,227	401,262	305,529	2,196,052	14,741,001	10,874,104	71,686	28,598,861
Investment securities								
– available-for-sale	–	2,679,490	–	140,602	1,015,487	236,931	542,009	4,614,519
– held-to-maturity	–	241,768	357,940	641,668	2,268,591	1,163,123	–	4,673,090
	54,657	4,806,413	663,469	2,978,322	18,025,079	12,274,158	613,695	39,415,793
Liabilities								
Debt securities issued	–	949,054	5,190,505	6,641,483	13,795,482	2,358,946	–	28,935,470

The Group	Repayable on demand HK$'000	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Undated HK$'000	Total HK$'000
As at 31 December 2005 (restated)								
Assets								
Cash and short-term funds	44,170	2,444,357	6,800	–	–	–	–	2,495,327
Loan portfolio	40,852	470,633	393,300	2,857,195	14,064,178	15,691,936	86,611	33,604,705
Investment securities								
– available-for-sale	–	851,092	308,962	–	419,415	–	410,504	1,989,973
– held-to-maturity	–	–	659,497	506,000	2,182,125	1,177,272	–	4,524,894
	85,022	3,766,082	1,368,559	3,363,195	16,665,718	16,869,208	497,115	42,614,899
Liabilities								
Debt securities issued	–	1,279,677	1,906,461	8,928,218	11,520,785	4,360,726	–	27,995,867
Mortgage-backed securities issued	14	12,745	1,690	1,027,629	1,939,326	2,182,972	–	5,164,376
	14	1,292,422	1,908,151	9,955,847	13,460,111	6,543,698	–	33,160,243

The Company	Repayable on demand HK$'000	Up to 1 month HK$'000	Over 1 month to 3 months HK$'000	Over 3 months to 1 year HK$'000	Over 1 year to 5 years HK$'000	Over 5 years HK$'000	Undated HK$'000	Total HK$'000
As at 31 December 2005								
Assets								
Cash and short-term funds	41,976	2,425,562	6,800	–	–	–	–	2,474,338
Loan portfolio	16,491	340,425	336,810	2,496,468	12,216,479	13,979,402	84,349	29,470,424
Investment securities								
– available-for-sale	–	851,092	308,962	–	419,415	–	410,504	1,989,973
– held-to-maturity	–	–	659,497	506,000	2,182,125	1,177,272	–	4,524,894
	58,467	3,617,079	1,312,069	3,002,468	14,818,019	15,156,674	494,853	38,459,629
Liabilities								
Debt securities issued	–	1,279,677	1,906,461	8,928,218	11,520,785	4,360,726	–	27,995,867

3.6. Mortgage Insurance Risk

The Company offers mortgage insurance which provides cover to the Approved Seller/Servicers for credit losses of up to 25% of the property value of a mortgage loan where the loan amount has exceeded 70% of the property value at origination.

The risk under any one insurance contract is the possibility that the insured event occurs and the uncertainty of the amount of the resulting claim. By the very nature of an insurance contract, this risk is random and therefore unpredictable.

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 are 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 mortgage insurance risks accepted and within each of the key categories to achieve a sufficiently large population of risks to reduce the variability of the expected outcome.

The frequency and severity of claims can be affected by several factors. The most significant are a downturn of the economy and a slump in the local property market. Economic downturn, which may cause a rise in defaulted payment, affects the frequency of claims. A drop in property prices, where the collateral value falls below the outstanding balance of the mortgage loan, will increase the severity of claims.

The Group manages these risks by adopting a set of prudent insurance eligibility criteria. To ensure sufficient provision is set aside for meeting future claim payments, the Group calculates technical reserves on prudent liability valuation assumptions and the method prescribed in the regulatory guidelines. The Group also takes out quota-share reinsurance from its approved mortgage reinsurers in an effort to limit its risk exposure. The Group conducts comprehensive assessment including the financial strength and credit ratings of the mortgage reinsurers in accordance with the approved selection framework set by the Credit Committee. The approved mortgage reinsurers are subject to periodic reviews.

3.7. Fair values of Financial Assets and Liabilities

The following table summarises the carrying amounts and fair values of those financial assets and liabilities not wholly presented on the Group's balance sheet at their fair value. Bid prices are used to estimate fair values of assets, whereas offer prices are applied for liabilities.

	Carrying value		Fair value	
	As at 31 December 2006 HK$'000	As at 31 December 2005 HK$'000 Restated	**As at 31 December 2006 HK$'000**	As at 31 December 2005 HK$'000 Restated
Financial assets				
Cash and short-term funds	**1,914,806**	2,495,327	**1,914,806**	2,495,327
Loan portfolio, net	**32,394,092**	33,548,858	**32,394,092**	33,548,858
Investment securities – held-to-maturity	**4,673,090**	4,524,894	**4,634,046**	4,473,414
Financial liabilities				
Other liabilities	**4,120,474**	4,278,202	**4,120,474**	4,278,202
Debt securities issued	**28,935,470**	27,995,867	**28,955,238**	28,002,890
Mortgage-backed securities issued	**5,361,260**	5,164,376	**5,354,783**	5,155,390

(a) Cash and short-term funds

Cash and short-term funds include bank deposits. The fair value of floating-rate deposits is the carrying amount. The estimated fair value of fixed-rate deposits, which are normally less than 3 months, is based on discounted cash flows using prevailing money-market interest rates for debts with similar credit risk and remaining maturity. Therefore, the fair value of the deposits is approximately equal to its carrying value.

(b) Loan portfolio, net, and mortgage-backed securities issued under the MBS Pass-Through Programme

Loan portfolio is stated net of impairment allowance. A very insignificant portion of loan portfolio bears interest at fixed rate. Therefore, the carrying value of loan portfolio and the mortgage-backed securities issued is a reasonable estimate of the fair value.

(c) Investment securities

Investment securities include only interest-bearing assets held to maturity, as assets available-for-sale are measured at fair value. Fair value for held-to-maturity assets are based on market prices or broker/dealer price quotations. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

(d) Debt securities issued

The aggregate fair value is calculated based on quoted market prices. For those notes where quoted market prices are not available, a discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity.

(e) Mortgage-backed securities issued under the Bauhinia MBS Programme

The aggregate fair value is calculated based on quoted market prices. For those notes where quoted market prices are not available, a discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity.

(f) Other liabilities

Other liabilities represent the deferred consideration used for credit enhancement on the mortgage loans purchased from the Government of the Hong Kong Special Administrative Region ("HKSAR") in December 2003 and January 2004. The fair value of other liabilities is their carrying amount.

(g) Financial instruments measured at fair value in the financial statements

The total amount of the change in fair value estimated using a valuation technique that was recognised in profit or loss during the year is HK$25,263,000 (2005: HK$14,687,000). There are no (2005: nil) financial instruments measured at fair value using a valuation technique that is not supported by observable market data.

4. Critical Accounting Estimates and Assumptions

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

4.1. Impairment Allowances on Loan Portfolio

The Group reviews its loan portfolio to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the income statement, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group or economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

4.2. Fair Value of Derivatives

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair value, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are validated before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk, volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

4.3. Impairment of Available-for-sale Investments

The Group determines that available-for-sale investments are impaired when there has been a significant or prolonged decline in the fair value below its cost. This determination of what is significant or prolonged requires judgement. In making this judgement, the Group evaluates, among other factors, the normal volatility in listed price. In addition, impairment may be appropriate when there is evidence of a deterioration in the financial health of the investment, industry and sector performance, changes in technology, and operational and financing cash flows.

4.4. Profits Taxes

The Group is subject to profits taxes in Hong Kong. Significant estimates are required in determining the provision for profits taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Group recognises liabilities for anticipated tax issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact on the income tax and deferred tax provisions in the year in which such determination is made.

5. Interest Income

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
Loan portfolio	**1,783,988**	1,468,612
Cash and short-term funds	**129,553**	98,977
Investment securities – listed	**119,691**	73,610
Investment securities – unlisted	**261,375**	131,810
	2,294,607	1,773,009

Included within interest income is HK$1,317,000 (2005: HK$834,000) with respect to interest income accrued on impaired mortgage portfolio.

6. Interest Expense

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
Bank loans, debt and MBS issued wholly repayable within 5 years	**1,153,444**	778,701
Debt and MBS issued not wholly repayable within 5 years	**423,947**	332,757
	1,577,391	1,111,458

7. Other Income, Net

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
Early prepayment fees and late charges	**19,560**	27,967
Net insurance premiums earned (Note 11)	**102,394**	101,181
Exchange difference	**23,216**	5,217
Change in fair value of financial instruments (Note 19(a))	**(7,459)**	(2,112)
Dividend income from available-for-sale listed investments	**15,998**	–
Issuance costs of debt securities and MBS issued	**(4,196)**	(4,136)
Net loss on disposal of available-for-sale securities	**–**	(6,989)
Others	**4,897**	4,557
	154,410	125,685

Change in fair value of financial instruments represents the aggregate of (i) HK$17,804,000 (2005: HK$12,575,000) realised fair value gain on financial instruments designated as at fair value through profit or loss and (ii) HK$25,263,000 (2005: HK$14,687,000) of mark-to-market losses for derivatives and financial instruments under fair value hedges and those designated as at fair value through profit or loss.

8. Operating Expenses

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
Staff costs		
Salaries and benefits	**70,222**	71,511
Pension costs – defined contribution plans	**4,504**	4,239
Premises		
Rental	**6,368**	6,368
Others	**4,603**	4,259
Directors' emoluments	**–**	–
Depreciation	**10,594**	10,952
Consultancy fees	**6,817**	3,049
Other operating expenses	**14,691**	15,559
	117,799	115,937

Auditors' remuneration included HK$600,000 (2005: HK$485,000) and HK$479,000 (2005: HK$279,000) for audit and other services.

9. Write-back of Loan Impairment Allowances

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
Write-back of loan impairment allowances – collective assessment (Note 18 (b))	**8,473**	19,235

10. Taxation

(a) Taxation charge in the consolidated income statement represents:

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
Hong Kong profits tax		
– Provision for current year	**78,201**	87,767
– Underprovision in prior years	**1,933**	429
	80,134	88,196
Deferred taxation		
– (Credit)/charge for current year	**(507)**	1,076
	79,627	89,272

Hong Kong profits tax has been provided at the rate of 17.5% (2005: 17.5%) on the estimated assessable profit for the year. Deferred taxation is calculated in full on temporary differences under the liability method using a principal taxation rate of 17.5% (2005: 17.5%).

The taxation on the Group's profit before taxation differs from the theoretical amount that would arise using the taxation rate of Hong Kong as follows:

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
Profit before taxation	**762,300**	690,534
Calculated at a taxation rate of 17.5%	**133,403**	120,843
Income not subject to taxation	**(85,091)**	(52,608)
Expenses not deductible for taxation purposes	**29,382**	20,608
Underprovision in prior years	**1,933**	429
Taxation charge	**79,627**	89,272

(b) Provision for taxation/(Tax recoverable) in the balance sheet represents:

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Tax recoverable for Hong Kong profits tax	**–**	(5,053)	**–**	(4,994)
Provision for Hong Kong profits tax	**16,511**	–	**16,511**	–
Deferred tax liabilities	**27,810**	21,691	**28,019**	21,824
	44,321	16,638	**44,530**	16,830

There was no significant unprovided deferred taxation as at and for the year ended 31 December 2006.

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

	The Group				
	Accelerated tax depreciation HK$'000	Impairment allowances HK$'000	Tax losses HK$'000	Fair value changes HK$'000	Total HK$'000
As at 1 January 2005	3,407	(2,719)	–	–	688
Recognised in the income statement	5	1,194	(123)	–	1,076
Charged to equity (Note 28)	–	–	–	19,927	19,927
As at 31 December 2005	3,412	(1,525)	(123)	19,927	21,691
Recognised in the income statement	(347)	(84)	(76)	–	(507)
Charged to equity (Note 28)	–	–	–	6,626	6,626
As at 31 December 2006	**3,065**	**(1,609)**	**(199)**	**26,553**	**27,810**

	The Company			
	Accelerated tax depreciation HK$'000	Impairment allowances HK$'000	Fair value changes HK$'000	Total HK$'000
As at 1 January 2005	3,407	(2,699)	–	708
Recognised in the income statement	5	1,184	–	1,189
Charged to equity (Note 28)	–	–	19,927	19,927
As at 31 December 2005	3,412	(1,515)	19,927	21,824
Recognised in the income statement	(347)	(84)	–	(431)
Charged to equity (Note 28)	–	–	6,626	6,626
As at 31 December 2006	**3,065**	**(1,599)**	**26,553**	**28,019**

The amounts shown in the consolidated balance sheet and Company's balance sheet include deferred tax assets of HK$1,808,000 (2005: HK$1,648,000) and HK$1,599,000 (2005: HK$1,515,000) respectively to be recovered after more than twelve months.

11. Revenue Account for Mortgage Insurance Business

	The Group	
	2006 HK$'000	2005 HK$'000
Gross premiums written	**211,479**	459,465
Reinsurance premiums	**(112,891)**	(281,277)
Net premiums written	**98,588**	178,188
Decrease/(increase) in unearned premiums, net	**4,400**	(77,519)
Net premiums earned	**102,988**	100,669
(Provisions)/write-back for outstanding claims and claims incurred but not reported (Note 26)	**(594)**	512
Net premiums earned after provisions (Note 7)	**102,394**	101,181
Management expenses	**(7,529)**	(9,226)
Underwriting gains	**94,865**	91,955

The management expenses formed part of the operating expenses in Note 8.

12. Net Profit for the Year

The net profit for the year is dealt with in the financial statements of the Company to the extent of HK$681,767,000 (2005: HK$601,223,000).

13. Dividend

	The Company	
	2006 HK$'000	2005 HK$'000
Proposed dividend of HK$0.125 (2005: HK$0.125) per ordinary share	**250,000**	250,000

The dividend paid in 2006 in respect of 2005 was HK$250 million. The directors proposed a final dividend in respect of 2006 of HK$0.125 per ordinary share on 26 April 2007. The proposed dividend is not reflected as a dividend payable as at 31 December 2006.

14. Cash and Short-term Funds

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Cash at banks	**47,081**	44,170	**45,430**	41,976
Time deposits with banks	**1,867,725**	2,451,157	**1,483,893**	2,432,362
	1,914,806	2,495,327	**1,529,323**	2,474,338

For the purposes of the cash flow statement, cash and cash equivalents comprise the following balances with less than three months' maturity from the date of acquisition.

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Cash at banks	**47,081**	44,170	**45,430**	41,976
Time deposits with banks	**1,670,442**	2,451,157	**1,483,893**	2,432,362
Cash and cash equivalents	**1,717,523**	2,495,327	**1,529,323**	2,474,338

15. Interest and Remittance Receivables

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Interest receivable from				
– interest rate swap contracts	**339,240**	114,079	**337,137**	111,870
– investment securities	**107,254**	79,138	**107,255**	79,138
– time deposits with banks	**6,435**	1,371	**2,270**	1,318
Interest receivable & instalments, in transit from loan portfolio	**103,178**	195,240	**88,450**	157,361
	556,107	389,828	**535,112**	349,687

16. Prepayments, Deposits and other Assets

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Corporate club debentures	**750**	750	**750**	750
Others	**12,621**	14,907	**43,074**	46,660
	13,371	15,657	**43,824**	47,410

17. Derivative Financial Instruments

The Group uses the following derivative instruments for both hedging and non-hedging purposes:

Currency forwards represents commitments to purchase foreign and domestic currency, including undelivered spot transactions.

Currency and interest rate swaps are commitments to exchange one set of cash flows for another. Swaps result in an economic exchange of currencies or interest rates or a combination of all these. No exchange of principal takes place except for certain currency swaps. The Group's credit risk represents the potential cost to replace the swap contracts if counterparties fail to perform their obligations. This risk is monitored on an ongoing basis with reference to the current fair value, a proportion of the notional amount of the contracts and the liquidity of the market.

The notional amounts of certain types of financial instruments provide a basis for comparison with instruments recognised on the balance sheet but do not necessarily indicate the amounts of future cash flows involved or the current fair value of the instruments and, therefore, do not indicate the Group's exposure to credit or price risks. The derivative instruments become favourable (assets) or unfavourable (liabilities) as a result of fluctuations in market interest rates or foreign exchange rates relative to their terms. The aggregate contractual or notional amount of derivative financial instruments on hand, the extent to which instruments are favourable or unfavourable, and thus the aggregate fair values of derivative financial assets and liabilities, can fluctuate significantly from time to time. The fair values of derivative instruments held are set out below.

	The Group					
	2006			2005		
	Contract/ notional amount HK$'000	**Fair values: Assets HK$'000**	**Fair values: Liabilities HK$'000**	Contract/ notional amount HK$'000 Restated	Fair values: Assets HK$'000 Restated	Fair values: Liabilities HK$'000 Restated
(a) Derivatives designated as at fair value through profit or loss						
Interest rate swaps	**49,752,948**	**45,158**	**(48,441)**	40,007,850	33,371	(78,122)
Currency swaps	**58,467**	**–**	**(974)**	58,467	–	(1,306)
Currency forwards	**15,752,300**	**–**	**(20,189)**	–	–	–
		45,158	**(69,604)**		33,371	(79,428)
(b) Derivatives designated as fair value hedge						
Interest rate swaps	**25,198,946**	**217,579**	**(93,217)**	23,101,280	54,519	(264,971)
Currency swaps	**424,663**	**23**	**(131)**	82,896	–	(331)
		217,602	**(93,348)**		54,519	(265,302)
Total recognised derivative assets/(liabilities)		**262,760**	**(162,952)**		87,890	(344,730)

	The Company					
	2006			2005		
	Contract/ notional amount HK$'000	**Fair values Assets HK$'000**	**Fair values Liabilities HK$'000**	Contract/ notional amount HK$'000	Fair values Assets HK$'000	Fair values Liabilities HK$'000
(a) Derivatives designated as at fair value through profit or loss						
Interest rate swaps	**49,752,948**	**45,158**	**(48,441)**	40,007,850	33,371	(78,122)
Currency swaps	**58,467**	**–**	**(974)**	58,467	–	(1,306)
Currency forwards	**15,752,300**	**–**	**(20,189)**	–	–	–
		45,158	**(69,604)**		33,371	(79,428)
(b) Derivatives designated as fair value hedge						
Interest rate swaps	**21,958,946**	**208,888**	**(78,534)**	21,601,280	51,895	(229,156)
Currency swaps	**424,663**	**23**	**(131)**	82,896	–	(331)
		208,911	**(78,665)**		51,895	(229,487)
Total recognised derivative assets/(liabilities)		**254,069**	**(148,269)**		85,266	(308,915)

The replacement costs and potential future credit exposure amounts of the derivative contracts are as follows. These amounts do not take into account the effects of bilateral netting arrangements with the counterparties.

	The Group			
	2006		2005	
	Replacement cost HK$'000	**Potential future credit exposure HK$'000**	Replacement cost HK$'000 Restated	Potential future credit exposure HK$'000 Restated
Interest rate contracts	**598,804**	**149,434**	176,975	127,392
Exchange rate contracts				
– Currency swaps	**5,300**	**24,156**	293	3,752
– Currency forwards	**–**	**157,523**	–	–
	5,300	**181,679**	293	3,752
	604,104	**331,113**	177,268	131,144

	The Company			
	2006		2005	
	Replacement cost HK$'000	**Potential future credit exposure HK$'000**	Replacement cost HK$'000	Potential future credit exposure HK$'000
Interest rate contracts	**589,993**	**136,734**	174,053	119,892
Exchange rate contracts				
– Currency swaps	**5,300**	**24,156**	293	3,752
– Currency forwards	**–**	**157,523**	–	–
	5,300	**181,679**	293	3,752
	595,293	**318,413**	174,346	123,644

The replacement costs represent the cost of replacing all derivative contracts that have a positive value when marked to market. The potential future credit exposure amounts refer to the amount as computed in accordance with the Capital-to-Assets ratio guidelines (Note 35). The Group has not experienced any non-performance by its counterparties.

18. Loan Portfolio, Net

(a) Loan portfolio less allowance

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Mortgage portfolio				
Retained portfolio	**27,337,240**	29,528,436	**27,307,829**	29,470,424
Securitised portfolio (Note 30)	**3,796,048**	4,076,269	**–**	–
Non-mortgage portfolio	**1,291,032**	–	**1,291,032**	–
Allowance for loan impairment	**(30,228)**	(55,847)	**(28,367)**	(52,714)
	32,394,092	33,548,858	**28,570,494**	29,417,710

As at 31 December 2006, the mortgage portfolio had a weighted average remaining term of 9 years (2005: 10 years) on a contractual basis, without taking into account any prepayment of the mortgage loans. Final maturity of the mortgage portfolio is in the year 2047.

Total allowance for loan impairment as a percentage of the outstanding principal balances of the loan portfolio is as follows:

	The Group		The Company	
	2006	2005 Restated	**2006**	2005
Total allowance for loan impairment as a percentage of the gross loan portfolio	**0.09%**	0.17%	**0.10%**	0.18%

(b) Allowance for loan impairment

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Collective assessment				
As at 1 January, as previously reported	**52,774**	70,478	**52,714**	70,395
Effect of adopting HKAS 27 (revised)	**3,073**	3,669	**–**	–
	55,847	74,147	**52,714**	70,395
Loans written off as uncollectible	**(20,289)**	(63,609)	**(20,289)**	(63,609)
Released to income statement (Note 9)	**(8,473)**	(19,235)	**(7,201)**	(18,616)
Transfer from other receivables	**–**	59,530	**–**	59,530
Recoveries of loans written off	**3,143**	5,014	**3,143**	5,014
As at 31 December	**30,228**	55,847	**28,367**	52,714

Allowance for loan impairment was made after taking into account the current market value of the collateral of the delinquent loan.

Impaired loans collectively assessed under portfolio basis are analysed as follows:

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Gross impaired loan portfolio	**89,414**	132,050	**89,414**	132,050
Allowance for loan impairment	**(19,207)**	(44,058)	**(19,207)**	(44,058)
	70,207	87,992	**70,207**	87,992
Allowance for loan impairment as a percentage of gross impaired loan portfolio	**21.5%**	33.4%	**21.5%**	33.4%
Gross impaired loan portfolio as a percentage of gross loan portfolio	**0.3%**	0.4%	**0.3%**	0.4%

(c) Net investments in finance leases included in loan portfolio

	The Group and the Company		
	2006		
	Present value of minimum lease payments receivable HK$'000	**Interest income relating to future periods HK$'000**	**Total minimum lease payments receivable HK$'000**
Amounts receivable:			
– within one year	**121,613**	**60,105**	**181,718**
– after one year but within five years	**408,729**	**188,306**	**597,035**
– after five years	**760,690**	**200,581**	**961,271**
	1,291,032	**448,992**	**1,740,024**

There is no impairment allowance for finance lease receivable as at 31 December 2006 of the Group and the Company.

19. Investment Securities

(a) Available-for-sale securities

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Debt securities at fair value		
Unlisted	**3,625,784**	1,563,461
Listed in Hong Kong	**163,039**	16,008
Listed outside Hong Kong	**283,687**	–
Other securities at fair value		
Listed in Hong Kong	**542,009**	410,504
Total available-for-sale securities	**4,614,519**	1,989,973

Available-for-sale securities are analysed by categories of issuers as follows:

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Banks and other financial institutions	**2,916,136**	1,176,062
Corporate entities	**436,278**	233,458
Public sector entities	**553,694**	–
Others	**708,411**	580,453
	4,614,519	1,989,973

The movement in available-for-sale securities is summarised as follows:

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
As at 1 January	**1,989,973**	–
Additions	**21,051,103**	4,094,763
Disposals (sale and redemption)	**(18,602,056)**	(2,224,488)
Amortisation	**108,549**	9,245
Change in fair value	**56,843**	113,866
Exchange difference	**10,107**	(3,413)
As at 31 December	**4,614,519**	1,989,973

Change in fair value includes HK$18,977,000 of fair value gain attributed to available-for-sale securities held under fair value hedge as such the gain net of the fair value change of the hedging derivatives, HK$2,042,000, is included in income statement (Note 7).

(b) Held-to-maturity securities

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Debt securities at amortised cost		
Listed in Hong Kong	**586,009**	592,656
Listed outside Hong Kong	**1,012,062**	998,012
	1,598,071	1,590,668
Unlisted	**3,075,019**	2,934,226
Total held-to-maturity securities	**4,673,090**	4,524,894
Market value of listed securities – held-to-maturity	**1,579,872**	1,580,266

Held-to-maturity securities are analysed by categories of issuers as follows:

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Banks and other financial institutions	**2,347,894**	2,207,929
Corporate entities	**1,108,615**	1,094,916
Public sector entities	**871,082**	877,050
Central governments	**345,499**	344,999
	4,673,090	4,524,894

The movement in held-to-maturity securities is summarised as follows:

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
As at 1 January	**4,524,894**	4,093,253
Additions	**357,028**	6,054,641
Disposals (redemption)	**(209,631)**	(5,617,764)
Amortisation	**(6,507)**	841
Exchange difference	**7,306**	(6,077)
As at 31 December	**4,673,090**	4,524,894

20. Fixed Assets

	The Group and the Company				
	Leasehold improvement HK$'000	**Office equipment, furniture and fixtures HK$'000**	**Computers HK$'000**	**Motor vehicle HK$'000**	**Total HK$'000**
Cost					
As at 1 January 2006	7,176	5,888	93,280	539	106,883
Additions	552	185	6,831	226	7,794
Disposal/write-offs	–	(3)	(745)	(539)	(1,287)
As at 31 December 2006	**7,728**	**6,070**	**99,366**	**226**	**113,390**
Accumulated depreciation					
As at 1 January 2006	1,651	3,336	79,199	539	84,725
Charge for the year (Note 8)	1,131	1,042	8,383	38	10,594
Disposal/write-offs	–	(1)	(745)	(539)	(1,285)
As at 31 December 2006	**2,782**	**4,377**	**86,837**	**38**	**94,034**
Net book value					
As at 31 December 2006	**4,946**	**1,693**	**12,529**	**188**	**19,356**
As at 31 December 2005	5,525	2,552	14,081	–	22,158

21. Investment in a Subsidiary

	The Company	
	2006 HK$'000	2005 HK$'000
Unlisted shares, at cost	**1,000**	1,000
Due from a subsidiary	**31,180**	59,960
	32,180	60,960

The amount due from a subsidiary is unsecured and has no fixed term of repayment. Interest is charged at market rate.

The details of the subsidiary as at 31 December 2006 are:

Name	Place of incorporation	Principal activities	Nominal value of issued capital	Class of shares held	% of ordinary shares directly held
HKMC Mortgage Management Limited	Hong Kong	Mortgage purchases and servicing	HK$1,000,000 of HK$1 each	Ordinary	100%

22. Accounts Payable, Accrued Expenses and Other Liabilities

	The Group		The Company	
	2006 HK$'000	2005 HK$'000 Restated	**2006 HK$'000**	2005 HK$'000
Accounts payable and accrued expenses	**77,962**	79,792	**213,764**	219,413
Other payable	**–**	–	**1,082,089**	975,876
Other liabilities	**4,120,474**	4,278,202	**4,120,474**	4,278,202
Other provisions	**6,155**	7,347	**6,031**	7,196
	4,204,591	4,365,341	**5,422,358**	5,480,687

Other liabilities represented the deferred consideration used for credit enhancement on the mortgage loans purchased from the Government of the Hong Kong Special Administrative Region ("HKSAR") in December 2003 and January 2004.

In November 2005 and 2006, the Company sold HK$1 billion and HK$2 billion respectively of mortgage loans to Bauhinia MBS Limited which issued the same amount of MBS under the Bauhinia MBS Programme. The Company continues to recognise the asset in "Loan portfolio, net" to the extent of the guarantee and continuing involvement. A liability due to Bauhinia MBS Limited shown as "Other payable" has also been recognised. As at 31 December 2006, other payable was HK$1,082,089,000 (2005: HK$975,876,000) in the Company's balance sheet.

23. Insurance Liabilities and Reinsurance Assets

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Gross		
Unearned premiums	**622,959**	681,469
Claims reported and outstanding	**534**	1,930
Claims incurred but not reported	**1,363**	813
Total insurance liabilities, gross	**624,856**	684,212
Reinsurance		
Unearned premiums	**372,893**	427,003
Claims reported and outstanding	**(7)**	1,478
Claims incurred but not reported	**1,015**	697
Total reinsurers' share of insurance liabilities	**373,901**	429,178
Net		
Unearned premiums	**250,066**	254,466
Claims reported and outstanding	**541**	452
Claims incurred but not reported	**348**	116
Total insurance liabilities, net	**250,955**	255,034

24. Debt Securities Issued

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Debt securities carried at amortised cost		
DIP notes	**3,848,817**	3,900,000
Total debt securities carried at amortised cost	**3,848,817**	3,900,000
Debt securities designated as fair value hedge		
NIP notes	**–**	1,005,619
DIP notes	**17,694,653**	15,996,080
RBIP and other notes	**4,410,475**	4,494,241
Total debt securities designated as fair value hedge	**22,105,128**	21,495,940
Debt securities designated as at fair value through profit or loss upon initial recognition		
DIP notes	**2,159,916**	1,934,939
RBIP and other notes	**821,609**	664,988
Total debt securities designated as at fair value through profit or loss upon initial recognition	**2,981,525**	2,599,927
Total debt securities issued	**28,935,470**	27,995,867

During the year, the Group designated on initial recognition HK$405,200,000 nominal value of such financial liabilities as at fair value through profit or loss. The fair value changes are attributable to changes in benchmark interest rates for the debt securities designated as at fair value through profit or loss. The carrying amount of the financial liabilities designated as at fair value through profit or loss upon initial recognition is HK$87,482,000 (2005: HK$63,900,000) lower than the amount that the Group would be contractually required to pay at maturity to the note holders.

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
As at 1 January	**28,248,003**	35,494,740
Issuance for the year	**13,343,663**	5,101,063
Less: Redemption for the year	**(12,699,326)**	(12,347,800)
Total nominal value	**28,892,340**	28,248,003
Unamortised portion of discount	**(89,989)**	(11,342)
Fair value adjustment	**133,119**	(240,794)
As at 31 December	**28,935,470**	27,995,867

Notes issued during the year comprise:

	The Group and the Company	
	DIP HK$'000	**RBIP HK$'000**
Amount issued at nominal value	**12,053,000**	**1,290,663**
Consideration received	**12,006,400**	**1,216,500**

All the debt securities issued are unsecured obligations of the Group, and are issued for the purposes of providing general working capital and refinancing.

25. Mortgage-backed Securities Issued

	The Group	
	2006 HK$'000	2005 HK$'000 Restated
MBS at amortised cost		
MBS Programme	**277,844**	409,842
Bauhinia MBS Programme	**1,849,408**	3,287,725
	2,127,252	3,697,567
MBS designated at fair value hedge		
Bauhinia MBS Programme	**3,234,008**	1,466,809
Total MBS issued	**5,361,260**	5,164,376
As at 1 January	**5,197,567**	5,869,148
Issuance for the year	**2,000,000**	1,000,000
Less: Redemption for the year	**(1,830,315)**	(1,671,581)
Total nominal value	**5,367,252**	5,197,567
Fair value adjustment	**(5,992)**	(33,191)
As at 31 December	**5,361,260**	5,164,376

All the MBS are collateralised obligation of the SPEs, and are issued for the purpose of providing funds to purchase mortgage portfolios from the Company. HK$4,878,137,000 of mortgage portfolio are collateralised for the MBS issued (Note 33).

26. Provisions for Mortgage Insurance Business

Provisions for outstanding claims under the mortgage insurance business are recorded net of recoveries from the approved reinsurers. For the year ended 31 December 2006, provision for claims of HK$201,000 (2005: HK$698,000) for risk-sharing business was written back in the income statement of the Group. The gross claim (net of recovery from Authorized Institutions) was HK$2,696,000 (2005: HK$944,000), of which HK$1,901,000 (2005: HK$758,000) was recovered from the approved reinsurers.

27. Share Capital

	2006 and 2005 HK$'000
Authorized	
3 billion ordinary shares of HK$1 each	**3,000,000**
Issued and fully paid	
2 billion ordinary shares of HK$1 each	**2,000,000**

28. Other Reserves

	The Group and the Company		
	Contingency reserve HK$'000	Fair value reserve HK$'000	Total HK$'000
As at 1 January 2005	41,670	–	41,670
Transfer of 50% of net risk premium earned from retained profits	20,055	–	20,055
Change in fair value of available-for-sale securities	–	113,866	113,866
Tax effect (Note 10(b))	–	(19,927)	(19,927)
As at 31 December 2005	61,725	93,939	155,664
As at 1 January 2006	61,725	93,939	155,664
Transfer of 50% of net risk premium earned from retained profits	22,953	–	22,953
Change in fair value of available-for-sale securities	–	37,866	37,866
Tax effect (Note 10(b))	–	(6,626)	(6,626)
As at 31 December 2006	**84,678**	**125,179**	**209,857**

29. Material Related Party Transactions

(a) Related parties are those parties which have the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence. Related parties may be individuals or other entities.

During the year, the Company entered into various transactions with related parties on an arm's length and commercial basis. The nature of the relationship is set out in the following table:

Name	Interests	Nature of related transaction – see the notes below
The Honourable Henry TANG Ying Yen, GBS, JP	Financial Secretary Controller of the Exchange Fund	(1) (3) (9)
Joseph YAM Chi Kwong, GBS, JP	Chief Executive of the Hong Kong Monetary Authority	(2) (3) (9)
Peter PANG Sing Tong, JP	Deputy Chief Executive of the Hong Kong Monetary Authority	(2) (3) (9)
CHOI Yiu Kwan, JP	Deputy Chief Executive of the Hong Kong Monetary Authority	(2) (3) (9)
The Honourable CHAN Kam Lam, SBS, JP	Legislative Councillor Member of The Hong Kong Housing Authority	(4)
Kenny LAM Kin Sun (retired on 28 April 2006)	Senior Vice President Global Financial Markets DBS Bank Ltd. Hong Kong Branch	(10)
David LAM Yim Nam (retired on 28 April 2006)	Deputy Chief Executive Bank of China (Hong Kong) Limited	(4) (5) (6) (7)
Dr. the Honourable David LI Kwok Po, GBS, LLD (Cantab), JP	Chairman and Chief Executive of The Bank of East Asia, Limited	(4) (5) (6) (7)
The Honourable Frederick MA Si Hang, JP	Secretary for Financial Services and the Treasury Official member of The Hong Kong Housing Authority	(1) (4)

Name	Interests	Nature of related transaction – see the notes below
Nicholas John SIBLEY	Head of Personal Financial Services Asia-Pacific The Hongkong and Shanghai Banking Corporation Limited Director of HSBC Insurance (Asia) Limited	(4) (5) (6) (7) (8)
The Honourable SIN Chung Kai, JP	Legislative Councillor Member of The Hong Kong Housing Authority	(4)
The Honourable Michael SUEN Ming Yeung, GBS, JP	Secretary for Housing, Planning and Lands Chairman of The Hong Kong Housing Authority	(1) (4)
Eddie TAN Cheng Soo	Regional Treasurer of Global Consumer Bank, Asia Pacific, Citibank, N.A., Singapore Branch (formerly Managing Director and Head of Emerging Markets Sales & Trading & Country Treasurer, Hong Kong, Citigroup (until 5 November 2006) and Director of Citicorp International Limited (until 1 December 2006))	(11)

(1) In 2006, the Company purchased about HK$107 million of mortgage loans from the Government of HKSAR (2005: HK$174 million).

(2) The Company is a member of the Central Moneymarkets Unit Service operated by the Hong Kong Monetary Authority ("HKMA") which provides custodian and clearing agent services for the debt securities issued by the Company. In 2006, the Company paid HK$0.8 million (2005: HK$0.4 million) by way of fees to the HKMA for such services.

(3) The Exchange Fund through HKMA has provided the Company with a HK$10 billion revolving credit facility. As at 31 December 2006, there was no outstanding balance (2005: nil).

(4) Being an executive director or senior officer of a financial institution or organisation as specified under the column headed "Interests" in the above table which has entered into an agreement with the Company in respect of the purchase of mortgage loans by the Company from time to time under the Mortgage Purchase Programme.

(5) Being an executive director or senior officer of a financial institution or organisation as specified under the column headed "Interests" in the above table which has entered into an agreement with the Company in respect of the application for mortgage insurance cover from time to time under the Mortgage Insurance Programme.

(6) Being an executive director or senior officer of a financial institution as specified under the column headed "Interests" in the above table which has entered into an agreement with the Company, as primary dealer or selling group member in the HK$40 Billion Debt Issuance Programme.

(7) Being an executive director or senior officer of a financial institution as specified under the column headed "Interests" in the above table which has entered into an agreement with the Company, as a placing bank in the HK$20 Billion Retail Bond Issuance Programme.

(8) Being an executive director or senior officer of a financial institution as specified under the column headed "Interests" in the above table which has entered into an agreement with the Company, as arranger or lead manager/co-lead manager in one or more of the Company's MBS issues, including the US$3,000,000,000 Bauhinia Mortgage-Backed Securitisation Programme.

(9) On 21 April 2004, the Company entered into a lease for a period of 6 years commencing on 1 January 2005 with The Financial Secretary Incorporated ("FSI") by which the FSI let to the Company Suite 7902 on 79th Floor and the whole of the 80th Floor, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. At the direction of the FSI, the Company pays the rental to the HKMA. In 2006, the Company paid HK$6.4 million (2005: HK$6.4 million) of rental to the HKMA.

(10) DBS Bank Ltd. is the parent company of DBS Bank (Hong Kong) Limited. DBS Bank (Hong Kong) Limited has entered into agreements with the Company in respect of the matters set out in paragraphs (4), (5), (6) and (7) above.

(11) Citigroup is the parent company of Citibank (Hong Kong) Limited and Citicorp International Limited. Citibank (Hong Kong) Limited has entered into agreements with the Company in respect of the matters set out in paragraphs (4), (5) and (7) above. Citicorp International Limited has entered into agreements with the Company in respect of the matters set out in paragraphs (6) and (8) above.

(b) Key management personnel

Key management are those persons having authority and responsibility for planning, directing and controlling the activities of the Group, directly or indirectly, including directors and senior officers.

Key management personnel compensation for the year comprises:

	2006 HK$'000	2005 HK$'000
Salaries and other short-term employee benefits	**11,260**	11,772
Post-employment benefits	**784**	832
	12,044	12,604

30. Special Purpose Entities and Securitisations

The Company uses two special purpose entities ("SPE") to securitise mortgage portfolio that result in the transfer of mortgage portfolio to two SPEs. These transfers may give rise to full or partial derecognition of the mortgage portfolio concerned from the Company's balance sheet.

Full derecognition occurs when the Company transfers its contractual right to receive cash flows from the mortgage portfolio and substantially all the risks and rewards of ownership.

Partial derecognition occurs when the Company sells or otherwise transfers mortgage portfolio in such a way that some but not substantially all of the risks and rewards of ownership are transferred but control is retained. These mortgage portfolio are recognised on the balance sheet to the extent of continuing involvement.

The majority of mortgage portfolio transferred to the SPEs, that do not qualify for full derecognition, are MBS guaranteed by the Company.

The rights and obligations that the Company retains from its continuing involvement in securitisations are initially recorded as an allocation of the fair value of the financial asset between the part that is derecognised and the part that continues to be recognised on the date of transfer. The following analyses the carrying amount of mortgage loans transferred to Bauhinia MBS Limited at 31 December 2006, to the extent of the Company's continuing involvement, that qualified for partial derecognition from the Company's balance sheet during the year.

	Carrying amount of assets transferred HK$'000	Carrying amount of assets recognised HK$'000
Mortgage-backed securitisation during the year	**1,740,000**	**260,000**

HKAS INT-12 requires consolidation of SPEs when from the substance of the relationships between the SPE and the reporting entity indicates that the SPE is controlled by that entity. This results in consolidating back the transferred assets to the consolidated balance sheet. The following summarises the outstanding principal balances of the mortgage portfolio transferred to the SPEs in all years prior to 2005 that were derecognised from the Company's balance sheet but were consolidated back to the consolidated balance sheet as a result of HKAS INT-12.

	2006 HK$'000	2005 HK$'000
HKMC Funding Corporation (1) Limited	**273,496**	404,689
Bauhinia MBS Limited	**3,522,552**	3,671,580
Mortgage portfolio transferred to the SPEs (Note 18(a))	**3,796,048**	4,076,269

31. Commitments

(a) Capital

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Authorized but not contracted for	**6,638**	7,756

(b) Operating leases

The Group leases the office premises under operating leases. The leases of the office premises run for an initial period of six years and include an option to renew at the then current open market rent. Total future minimum lease payments under non-cancellable operating leases at the balance sheet date are analysed as follows:

	The Group and the Company	
	2006 HK$'000	2005 HK$'000
Office premises		
not later than one year	**6,368**	6,368
later than one year and not later than five years	**19,103**	25,471
	25,471	31,839

32. Mortgage Insurance Business

The Company operates its mortgage insurance business on a risk-sharing basis, and retains up to 50% of the risk exposure under its mortgage insurance covers with the remaining risk exposure being ceded to its approved reinsurers.

As at 31 December 2006, the total risk-in-force was approximately HK$8.14 billion (2005: HK$8.05 billion) of which HK$5.22 billion (2005: HK$5.41 billion) was ceded to the approved reinsurers and the balance of HK$2.92 billion (2005: HK$2.64 billion) was retained by the Company.

33. Pledged Assets

SPEs have charged their assets as securities or otherwise transferred by way of security for issuing guaranteed or non-guaranteed MBS in accordance with the provisions under the relevant securitisation programmes. The security trustee appointed under the relevant securitisation programmes will enforce the securities over the relevant pledged assets when the relevant SPE (and, in the case of guaranteed MBS, the Company as guarantor) defaults in payment under any series of MBS or otherwise on the occurrence of an event of default in respect of any series of MBS.

	The Group	
	2006 **HK$'000**	2005 HK$'000
Assets pledged		
Time deposits with banks	**383,833**	18,795
Mortgage portfolio	**4,878,137**	5,052,145
Interest receivable	**8,605**	16,251
	5,270,575	5,087,191

	The Group	
	2006 **HK$'000**	2005 HK$'000
Secured liabilities		
Mortgage-backed securities issued (Note 25)	**5,361,260**	5,164,376

Mortgage portfolio pledged included securitised mortgage portfolio recorded in the SPE's book (Note 30) and the transferred mortgage portfolio continued to be recognised as assets in "Loan portfolio, net" to the extent of the guarantee and continuing involvement (Note 22).

34. Contingent Liabilities

The contractual amounts of the guarantees provided under the MBS programmes are:

	The Company	
	2006 **HK$'000**	2005 HK$'000
Guarantees	**3,627,252**	5,197,567

35. Capital-to-Assets Ratio

To ensure that the Group is managed in a prudent manner, the Financial Secretary of the Government of the Hong Kong Special Administrative Region has issued guidelines in respect of the minimum Capital-to-Assets ratio ("CAR") to be maintained by the Group. The minimum CAR stipulated in the guidelines is 5%.

	The Group	
	2006	2005 Restated
Capital-to-Assets ratio	**11.2%**	12.0%

The Capital-to-Assets ratio is calculated as a ratio, expressed as a percentage, of the Group's total capital base to the sum of its total on-balance sheet assets and total off-balance sheet exposures.

36. Approval of Financial Statements

The financial statements were approved by the Board of Director on 26 April 2007.