STRONG Performance

“The Corporation achieved a profit after tax of HK$600.6 million, with the return on shareholder’s equity at 13.6%. For the second year, the Corporation declared a dividend of HK$250 million.”

INCOME STATEMENT

Financial performance

The Hong Kong economy continued to grow robustly in 2005 with GDP up by 7.3%. This solid expansion in the economy was underpinned by the strong performance of external trade and the upsurge in consumer spending and investment. Along with the rise in GDP, the consumer price index gradually went up to 1.1% and the unemployment rate improved from an annual average of 6.8% to 5.6% in 2005.

The strong recovery in the economy coincided with a progressive rise in interest rates, which cooled down the activities in the property market in the second half of the year. Nevertheless, competition among banks for mortgage loans remained keen. With the influx of funds that sustained a still high level of liquidity in the banking market and with the improvement in borrowers' credit, banks reverted to offering low mortgage rates to attract home buyers to the market. Under the rising interest rate environment and the highly competitive mortgage market, the HKMC reported a profit after tax of HK$600.6 million for 2005, a decrease of 9.5% compared with 2004. (Figures 1 and 2)

Operating profit before impairment losses fell by HK$181.5 million, or 21.3% to HK$671.3 million. The reduction in net interest income by 23.5% outweighed a 3.4% increase in other income and 3.5% reduction in operating expenses.

The return on shareholders' equity remained strong at 13.6% (2004: 17.1%), while the return on assets improved to 1.5% (2004: 1.3%). Although operating expenses were contained by more effective cost control than 2004, contraction of the income base increased the cost-to-income ratio to 14.6% (2004: 12.2%). The capital-to-assets ratio further strengthened to 12% from 9.3% 2004, well above the guideline of a minimum of 5% stipulated by the Financial Secretary.

The net interest income for the year dropped by 23.5% from HK$811.7 million to HK$620.6 million (Figure 3), reflecting mainly the high base effect in 2004

Figure 1

Summary of financial performance

	2005 HK$ million	2004 HK$ million
Operating profit before impairment losses	**671.3**	852.8
Profit before tax	**689.9**	763.4
Profit after tax	**600.6**	664.0
Return on shareholders' equity	**13.6%**	17.1%
Return on assets	**1.5%**	1.3%
Cost-to-income ratio	**14.6%**	12.2%
Capital-to-assets ratio	**12.0%**	9.3%

Figure 2

Profit after tax

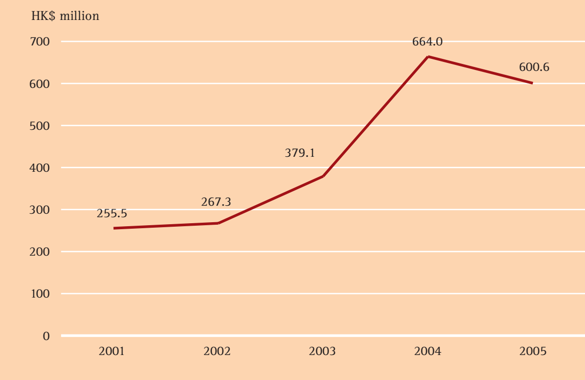


Figure 3

Net interest income

	2005 HK$'000	2004 HK$'000
Interest income	**1,584,531**	1,021,874
Interest expense	**(963,898)**	(210,165)
Net interest income	**620,633**	811,709
Average interest-earning assets	**39,710,204**	49,408,963
Net interest margin	**1.6%**	1.6%
Net interest spread on interest-bearing liabilities[1]	**1.2%**	1.6%

1 Net interest spread on interest-bearing liabilities = Return on interest-earning assets – Funding cost on interest-bearing liabilities

Figure 4

Major source of other income

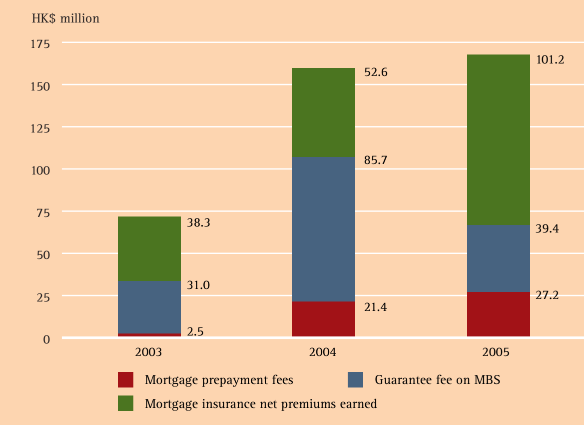


Figure 5

Operating expenses

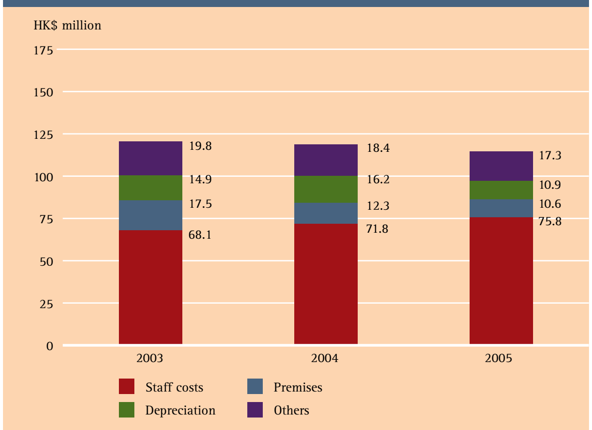


Figure 6

Allowance for loan impairment/provisions for bad and doubtful loans

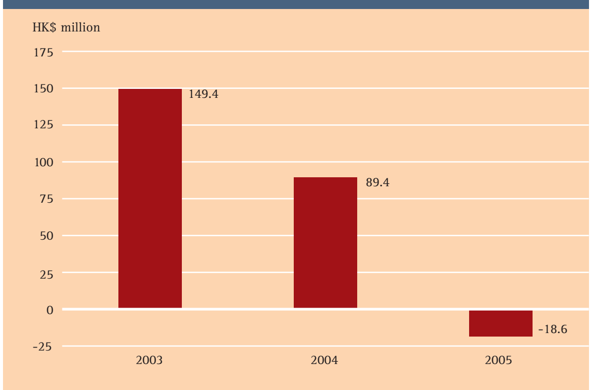


Figure 7

Ratios

	2005	2004
Delinquency ratio for mortgage portfolio overdue for more than 90 days	0.22%	0.36%
Total loan provisions as a percentage of the gross mortgage portfolio	0.18%	0.33%[2]

2 In 2004, loans overdue for 180 days or more, with collateral repossessed or mortgagors who declared bankruptcy, were written down to the forced sale value of the properties and reclassified from "Mortgage portfolio, net" to "Other receivables, net". Without accounting for this reclassification, loan provisioning was 0.49% of the outstanding principal balance of the total mortgage loans. In 2005, these balances are reclassified from "Other receivables, net" to "Mortgage portfolio, net".

attributable to the exceptionally wide Prime-HIBOR spread prevailing in 2004 and also a reduction in the Corporation's average interest-earning assets in 2005. The Prime-HIBOR spread contracted from a monthly average of 4.7% in 2004 to 3.3% in 2005 and the net interest spread on interest bearing liabilities narrowed from 1.6% to 1.2%. Taking into account the shareholders' equity, the net interest margin remained healthy at 1.6%, the same as 2004.

Net other income

Net other income achieved a moderate growth of 3.4% to HK$165.3 million in 2005 (2004: HK$159.8 million). This was mainly attributable to the growth in fee income from mortgage insurance premiums earned and prepayment fees received, which was partially offset by the drop in fee income from guaranteed MBS. (Figure 4)

The HKMC operates the MIP business on a risk-sharing basis with four approved reinsurers and up to 50% of the risk exposure under the mortgage insurance covers. Net mortgage insurance premiums written under the MIP increased sharply by 42.9% to HK$178.2 million, mainly on account of the increase of the maximum loan-to-value ratio to 95% and the rebound of property market in the first half of 2005. The MIP achieved a strong growth of 27.1% in new business underwritten and the market penetration rate rose from 16% to 20%. The risk-in-force borne by us grew sharply by 49% to HK$2.6 billion in 2005. As a result, the net premium earned for the year increased by 92.4% from HK$52.6 million to HK$101.2 million.

Triggered by the continual improvement in the property market, early prepayment fees increased significantly by 27.1% to HK$27.2 million (2004: HK$21.4 million).

The HKMC guarantees, for a fee, the timely payment of principal and interest to the note holders of the MBS issued by Bauhinia MBS Limited and HKMC Funding Corporation (1) Limited. During 2005, new MBS issued was HK$1 billion, which together with regular principal repayment of mortgages reduced the outstanding principal amount of MBS by 12% to HK$5.2 billion. With the reduction in outstanding amount of MBS and the tightening of Prime-HIBOR spread on the Prime-based securitised mortgages, the guarantee and other fee income from the MBS decreased by 54% from HK$85.7 million to HK$39.4 million in 2005.

Operating expenses

The HKMC continued to maintain stringent cost controls to contain expenses while seeking to expand the scope of business. Operating expenses fell by 3.5% to HK$114.6 million as compared to 2004. Staff costs increased by 5.6% to HK$75.8 million, which, as a result of headcount increase for business expansion and salary adjustments, accounted for 66.1% of total operating expenses (2004: HK$71.8 million and 60.5%). The increase in staff costs was offset by the full-year effect of the net savings in premises and other related expenses following the office relocation to Two International Finance Centre in July 2004. Premises rental and the related costs dropped by HK$1.6 million to HK$10.6 million. Depreciation charges on assets decreased substantially by 32.7% to HK$10.9 million (2004: HK$16.2 million). (Figure 5)

Allowance for loan impairment

Asset quality remained strong with the delinquency ratio falling from 0.36% to 0.22%. The previous approach of maintaining general and specific provisioning on mortgage portfolio was replaced by provisions for impairment losses assessed collectively and/or individually when objective evidence of impairment exists. The difference between the carrying amount and the recoverable amount of the asset is recognised as impairment. Collective assessment for loan impairment of HK$18.6 million was released to the income statement as a consequence of the improvement in the residential property market. This compared favourably with the charge of HK$89.4 million for general and specific provisions in 2004. (Figure 6)

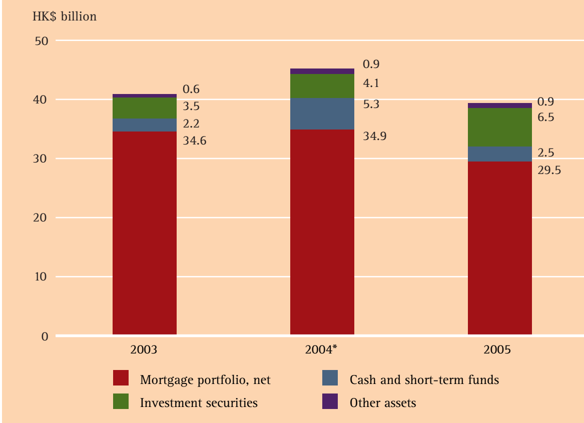
Total loan provisions accounted for 0.18% of the outstanding principal balance (HK$29.5 billion) of the retained mortgage portfolio as at end-2005. (Figure 7)

BALANCE SHEET

The total assets decreased by HK$5.9 billion to HK$39.4 billion (2004: HK$45.3 billion), mainly due to the contraction of mortgage portfolio by HK$5.4 billion.

Figure 8

Asset deployment



* *restated in accordance with HKFRS 4*

Figure 9

Mortgage portfolio, net

	2005 HK$'000	2004 HK$'000
Gross mortgage portfolio	**29,528,436**	35,052,688
Allowance for loan impairment/ provisions for bad and doubtful loans	**(52,774)**	(114,108)
Mortgage portfolio, net	**29,475,662**	34,938,580

Investment securities rose by HK$2.4 billion to HK$6.5 billion while cash and short-term funds were reduced by HK$2.8 billion to HK$2.5 billion. (Figure 8)

Mortgage portfolio

The HKMC purchased an aggregate amount of HK$2.9 billion of mortgage loans in 2005 (2004: HK$11.4 billion). The average prepayment rate of the retained mortgage portfolio (including those securitised mortgages carrying HKMC's guarantee) increased from 12.5% in 2004 to 15.4% for 2005. Given the high prepayment rate of the mortgage portfolio and the reduction in mortgage purchases in 2005, the mortgage portfolio, including the HK$1 billion of mortgages securitised in 2005, recorded a net decrease by HK$5.4 billion to HK$29.5 billion. (Figure 9)

Investment securities

The HKMC's investment portfolio is mainly made up of bank deposits, certificates of deposit and bonds. It serves the objectives of income enhancement and as a liquidity buffer to support HKMC's business operations. Commencing 1 January 2005, the HKMC classified its investment portfolio into held-to-maturity investment and available-for-sale investment in accordance with Hong Kong's new accounting

Figure 10

Product	Minimum Capital-to-assets ratio
Mortgage Purchase Programme	
(i) regular mortgage loans	5% of regular mortgage loan portfolio (based on outstanding principal balance or committed amount plus accrued interest)
(ii) loans originated under the Home Starter Loan Scheme (HSLS) and Sandwich Class Housing Loan Scheme (SCHLS)	2% of HSLS and SCHLS loans (based on outstanding principal balance or committed amount plus accrued interest)
Mortgage-Backed Securities (MBS)	2% of MBS portfolio (based on outstanding principal balance plus accrued interest)
Mortgage Insurance Programme	0% of risk-in-force value of exposure covered by the reinsurance arrangement with Approved Reinsurers 5% of risk-in-force value of exposure not covered by the reinsurance arrangement
Securitised mortgage loans transferred from the Corporation to the special purpose entities (SPE) that are qualified for derecognition from the Corporation's balance sheet before account consolidation of the SPE	0% of securitised mortgage loans
Securitised mortgage loans transferred from the Corporation to the SPE that are not qualified for derecognition from the Corporation's balance sheet before account consolidation of the SPE, where the mortgage-backed securities issued are:	
(i) guaranteed by the Corporation	2% of securitised mortgage loans
(ii) not guaranteed by the Corporation	5% of securitised mortgage loans

standards. Following the approval of the Board of Directors to increase the return on investment while mindful of the need to maintain the Corporation's high credit rating and strong funding capability, the HKMC expanded its investment activities in accordance with the approved investment guidelines. As at 31 December 2005, the total investment portfolio increased from HK$4.1 billion in 2004 to HK$6.5 billion including HK$2 billion of available-for-sale investment and HK$4.5 billion of held-to-maturity investment with funds redeployed from lower yielding cash and short-term funds.

Debt securities

The HKMC issued a total of HK$5.1 billion of Hong Kong dollar debts in 2005, comprising HK$4.5 billion debts under the DIP and HK$0.6 billion retail bonds under the RBIP. As at 31 December 2005, the total outstanding balance of the debts issued decreased significantly by 21.1% or HK$7.5 billion to HK$28 billion as compared with 2004. The decrease reflected the redemption of HK$12.3 billion debts matured in 2005. The average life of the retained mortgage portfolio was 10 years on a contractual basis while 41.2% of HKMC's outstanding debts would mature in the range of 1 to 5 years.

CAPITAL MANAGEMENT

The Financial Secretary has approved the following capital adequacy framework to account for different levels of risk embedded in the financial products under the Mortgage Purchase Programme, the two MBS Programmes and the MIP. (Figure 10)

The capital base, defined as shareholders' equity plus the allowance for loan impairment under collective assessment, grew by 12.5% from HK$4.0 billion to HK$4.5 billion in 2005. At the end of 2005, the aggregate amount of HKMC's on-balance sheet assets and off-balance sheet exposure was HK$37.3 billion, which mainly consisted of HK$22.8 billion of risk-weighted mortgage loans, HK$6.5 billion investment securities, HK$2.5 billion of cash and bank balances, HK$2.7 billion risk-weighted mortgage insurance exposure and HK$1.7 billion risk-weighted guarantee exposure under the MBS programmes. The capital-to-assets ratio ("CAR") stood well above the minimum level of 5% stipulated by the Financial Secretary, at a healthy level of 12% (2004: 9.3%), or equivalent to 24% (2004: 20.5%) when calculated in accordance with the capital adequacy framework under the Banking Ordinance.

DIVIDEND

At the Annual General Meeting held on 28 April 2006, Shareholders approved a final dividend of HK$0.125 per share (same as 2004), totalling HK$250 million, representing a dividend payout ratio of 41.6%.