Financial Review

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The global economy continued its growth in 2018, notwithstanding some momentum appeared to lose in the second half of the year. The trade conflict between the US and China, coupled with the continued normalisation of monetary policy by major advanced economies, clouded the global economic sentiment and led to heightened global financial volatility. In Mainland China, growth momentum showed some moderation but economic restructuring remained on track.

Hong Kong's economic growth moderated from 4.1% in the first half of 2018 to 2.1% in the second half of the year, with an overall 3% in 2018, higher than the trend growth rate of 2.8% over the past decade on the back of solid domestic and external demands. Inflation edged up to a still-moderated level in 2018, with a slight uptick in inflation momentum reflecting both external and domestic price pressures. At the same time, the labour market tightened further along with a decline in the unemployment rate to 2.8%, the lowest in more than 20 years. However, investment and business sentiment worsened. The negative sentiment has taken effect in the financial markets. Downside risk to growth has increased amid stronger external headwinds.

Income Statement

Financial Performance

Profit attributable to shareholders for 2018 was HK$127 million (2017: HK$806 million) **(Table 1)**. The decrease in profitability mainly reflected the accounting loss due to the annuity business of the HKMCA for maintaining prudent statutory reserves based on actuarial assumptions, the non-recurrence in 2018 of a one-off investment disposal gain in 2017, the decrease in exchange gains mainly arising from the revaluation of US dollar exposures in cash and debt investments, and resources utilised for supporting certain policy initiatives. Accordingly, return on equity reduced to 0.9% (2017: 8.6%) while cost-to-income ratio increased to 86.0% (2017: 26.8%). Notwithstanding the reported loss of the HKMCA, the embedded value (i.e., the sum of the total equity and present value of future profits) of its annuity business at the end of 2018 was about HK$5.2 billion, indicating that the business should be profitable in the long term. The capital adequacy ratio (**CAR**) remained solid at 26.8% (2017: 21.0%), which was well above the minimum requirement of 8% stipulated by the Financial Secretary. For the insurance subsidiaries in compliance with the capital requirements stipulated by the Insurance Authority (**IA**), the solvency ratios of the HKMCI and the HKMCA as at the end of 2018 were about 42 times and 34 times respectively.

Table 1

Summary of financial performance	2018[1] HK$ million	2017 HK$ million
Operating profit before impairment	**67**	829
Profit before tax	**67**	829
Profit attributable to shareholders	**127**[1]	806
Return on shareholders' equity	**0.9%**[1]	8.6%
Cost-to-income ratio	**86.0%**[1]	26.8%
Capital adequacy ratio	**26.8%**[1]	21.0%

[1] For comparison purposes, the adjusted profit attributable to shareholders, return on shareholders' equity and cost-to-income ratio for 2018 would be HK$515 million, 5.1% and 36.7% respectively after excluding the results of the HKMCA.

Net Interest Income

Owing to the increase in average interest-earning assets (mainly from cash and debt investments), partly offset by the tightening of Prime-HIBOR spread on loan portfolio, the HKMC Group earned a net interest income of HK$536 million, HK$28 million higher than that for 2017. The net interest margin was maintained at 1.1% **(Table 2)**.

Table 2

Net Interest Income	2018 HK$ million	2017 HK$ million
Net interest income	**536**	508
Average interest-earning assets	**50,972**	48,027
Net interest margin	**1.1%**	1.1%

Net Mortgage Insurance Premium Earned

New business underwritten under the MIP increased slightly to HK$32.5 billion in 2018 from HK$32.3 billion in 2017. The net premium receipts were amortised and recognised as income in accordance with the unexpired risks. Taking into account upfront incentives to banks, and claims incurred and provision of HK$3.7 million (2017: HK$1 million), the net premium earned was HK$222 million (2017: HK$196 million).

Net Insurance-related Results for Annuity Business

Net insurance-related results for annuity business (i.e., the sum of net premiums earned, net claims incurred, benefits paid, movement in policyholders' liabilities, and commission and levy expenses) recorded a loss of HK$550 million (2017: nil) mainly due to the prudent statutory reserving based on actuarial assumptions, whereas the investment returns on capital and premiums placed with the Exchange Fund were grouped under other income.

Other Income

Other income was HK$250 million (2017: HK$414 million), mainly including investment income from placements with the Exchange Fund of HK$185 million (2017: nil) and dividend income from investments of HK$59 million (2017: HK$83 million).

Operating Expenses

The Group continues to maintain stringent cost controls to contain expenses and improve operating efficiency. Operating expenses rose 35.5% year-on-year to HK$412 million, largely attributable to the implementation of the annuity business, which was less than budgeted. Staff costs, which were contained at 62.5% of total operating expenses, amounted to HK$258 million (2017: HK$196 million). Premises rentals and related costs were HK$59 million (2017: HK$39 million).

Allowance for Loan Impairment

Asset quality remained strong, with the delinquency ratio of the Group's mortgage portfolio staying low at 0.02% (2017: 0.06%). Taking into account the rundown in loan portfolio, and the low average current loan-to-value ratio of retained loan portfolio, a provision on loan impairment allowance of HK$0.02 million was recorded in 2018 according to the approved prudent provisioning policy. During the year, loans written off amounted to HK$1 million (2017: HK$2 million) with a recovery of HK$1 million (2017: HK$1 million).

Segmental Analysis

Table 3 below sets out the profit before tax contributed by various business segments for 2018.

Table 3

Year ended 31 December 2018	Asset Purchase and Servicing HK$ million	General Insurance HK$ million	Life Insurance HK$ million	Total
Profit/(Loss) before tax	360	173	(466)	67

In 2018, the Group reviewed and redefined its business segments after the completion of group restructuring and the launch of the annuity business, in order to provide clear and concise information. The asset purchase and servicing segment represents the results of the loan acquisition and servicing business as well as other activities, such as debt issuance. The general insurance segment represents the results of insurance and guarantee businesses under the MIP, the RMP, the PLIS and the SFGS. The life insurance segment represents the results of the annuity business, i.e., the HKMC Annuity Plan.

The profit before tax in 2018 for asset purchase and servicing was HK$360 million, mainly arising from net interest income of the loan and investment portfolios. General insurance's profit before tax in 2018 was HK$173 million, mainly attributable to net premiums earned from MIP and RMP. Life insurance recorded a loss before tax of HK$466 million in 2018, mainly due to the prudent statutory reserves based on actuarial assumptions provided for the annuity business of the HKMCA, partially offset by the investment returns from capital and premium placements with the Exchange Fund. Notwithstanding the reported loss of the HKMCA, the embedded value[1] of its annuity business at the end of 2018 was about HK$5.2 billion indicating that the business should be profitable in the long term.

Financial Position

Loan Portfolio

During the year, the Group purchased Hong Kong loan assets of about HK$0.3 billion (2017: HK$0.3 billion). After accounting for prepayments and repayments during the year, the outstanding balance of the loan portfolio recorded a rundown of HK$1.4 billion, leaving an outstanding balance of HK$6.4 billion.

Investment Securities

The Group adopts a prudent, low-risk approach in managing its surplus funds and investment activities in accordance with the investment guidelines approved by the Board. As at 31 December 2018, the total investment portfolio was HK$17.2 billion (2017: HK$17.4 billion), which included debt investments of HK$16.6 billion and exchange-traded bond funds and real estate investment trusts of HK$0.6 billion. There was no default loss from debt investments.

Placements with the Exchange Fund

As at 31 December 2018, the placements with the Exchange Fund arising from the capital and premium invesments of the HKMCA amounted to HK$7.7 billion (2017: nil).

Debt Securities Issued

In 2018, the Group issued HK$34.1 billion of debt securities under the MTN Programme. All the non-Hong Kong dollar debts issued under the MTN Programme were hedged into Hong Kong dollars or US dollars. The Group continued to adopt a prudent pre-funding strategy, with the total outstanding balance of the debt securities maintained at HK$37.3 billion as at 31 December 2018 (2017: HK$34.8 billion).

Key Off-balance Sheet Exposure

Mortgage Insurance Programme

The Group operates the MIP on a risk-sharing basis with approved reinsurers. At the end of 2018, the total risk-in-force was about HK$23.7 billion (2017: HK$21.1 billion), of which HK$4.0 billion (2017: HK$3.5 billion) was ceded to approved reinsurers. The off-balance sheet risk-in-force exposure borne by the Group increased to HK$19.7 billion (2017: HK$17.6 billion).

The provision for outstanding claims remained steady at 0.1% of the retained risk-in-force at year-end. The delinquency ratio remained healthy at 0.002% (2017: 0.003%).

Reverse Mortgage Programme

The Group operates the RMP as an insurer to provide mortgage insurance cover for a premium on reverse mortgage loans advanced by participating banks in Hong Kong. After taking into account the undrawn future payout of reverse mortgage loans, the risk-in-force exposure borne by the Group increased to HK$9.6 billion (2017: HK$6.9 billion), with the corresponding outstanding loan balance totalling HK$1.6 billion as at 31 December 2018.

[1] The embedded value is the sum of the total equity and the present value of future profits. The total equity includes HK$5 billion of capital injected to the HKMCA in April 2018.

Capital Management

In order to ensure that the Group would not incur excess risk when expanding its business and balance sheet in proportion to its capital base, capital adequacy and the use of capital were monitored closely by the Group. During the year, the Group was in compliance with the Guidelines on Capital Adequacy Ratio (**Guidelines**) issued by the Financial Secretary with reference to the Basel II risk-based capital adequacy framework.

In accordance with the Guidelines, the calculation of the CAR follows the basis of consolidation for financial reporting with the exclusion of regulated subsidiaries which are subject to separate requirements on the maintenance of adequate capital (i.e., the HKMCI and the HKMCA, as regulated by the IA). After excluding the investment cost of these unconsolidated regulated subsidiaries, the CAR remained solid at 26.8% as at 31 December 2018, well above the minimum ratio of 8% stipulated in the Guidelines on CAR.

The solvency ratios of the HKMCI and the HKMCA as at 31 December 2018 were about 42 times and 34 times respectively, well above the respective 200% and 150% minimum regulatory requirements stipulated by the IA.

Dividend

Having considered the capital requirements for business development, no dividend was declared for 2018 (2017: Nil).