Healthy and Sustainable Growth

Financial Review

The economy of Hong Kong experienced a robust recovery in 2010 following the recession in 2009. In light of improving income and job prospects, private consumption picked up and business sentiment remained optimistic in general, with strong growth momentum from both internal and external sectors. In particular, strong demand in Asian economies, combined with further revival in demand in the United States and Europe, greatly boosted Hong Kong's external trade, as well as trade-related and transportation services. Employment and income growth, together with a surge in public construction works, also supported private consumption and domestic fixed investment. All in all, the real GDP recorded a year-on-year growth of 6.8% and the unemployment rate fell to 4.0% in the fourth quarter, the lowest level since 2008.

The continuation of the ultra loose monetary stance in advanced economies and, in particular, a new round of quantitative easing by the United States, led to rising global liquidity, which caused inflation and asset prices to soar. Underlying consumer price inflation averaged 2.4%, up from 0.5% in 2009, due to the price pressure from imported sources, following renewed weakening of the US dollar, rising global food prices and higher inflation in Asia. Residential property prices climbed 21% as of December 2010 over a year ago, but showed signs of moderating towards the end of the year after the implementation of prudential measures by the Hong Kong Government to address concerns over a property price bubble caused by speculative investments in the property sector.

FIGURE 1
Summary of Financial Performance

	2010 HK$ million	2009 HK$ million
Operating profit before impairment	**1,387**	1,111
Profit before tax	**1,406**	1,150
Profit attributable to shareholders	**1,234**	1,006
Return on shareholders' equity	**17.5%**	16.2%
Return on assets	**2.2%**	1.6%
Cost-to-income ratio	**11.0%**	12.4%
Capital-to-assets ratio	**10.8%**	9.5%

Income Statement

Financial Performance

Riding on the robust recovery of the Hong Kong economy and the buoyant property market, the Corporation managed to achieve good financial results again in 2010. Profits attributable to shareholders amounted to HK$1,234 million in 2010 (**FIGURES 1** and **2**), representing a 22.7% increase over 2009. The growth was attributable to ample liquidity, excellent loan performance and increased contribution from mortgage insurance premium earned from loans underwritten under the Mortgage Insurance Program ("MIP").

Operating profit before impairment increased by HK$276 million, or 24.8%, to HK$1,387 million, supported by 153.4% growth in other income that more than offset the 6.5% reduction in net interest income.

The return on shareholders' equity rose to 17.5% (2009: 16.2%), while the return on assets climbed to 2.2% (2009: 1.6%). Despite increased commitment in risk management that lifted the operating expenses by 8.2%, the significant rise of 22.8% in operating income improved the cost-to-income ratio to 11.0% (2009: 12.4%). The capital-to-assets ratio remained robust at 10.8% (2009: 9.5%), well above the guideline of a minimum 5% stipulated by the Financial Secretary.

The average loan portfolio fell by HK$8.7 billion compared with that of 2009, as a result of the faster runoff of loan portfolio arising from increased refinancing activities in the property market, which was offset partially by an increase in cash and investments of HK$2 billion. Though both the

FIGURE 2
Profit Attributable to Shareholders

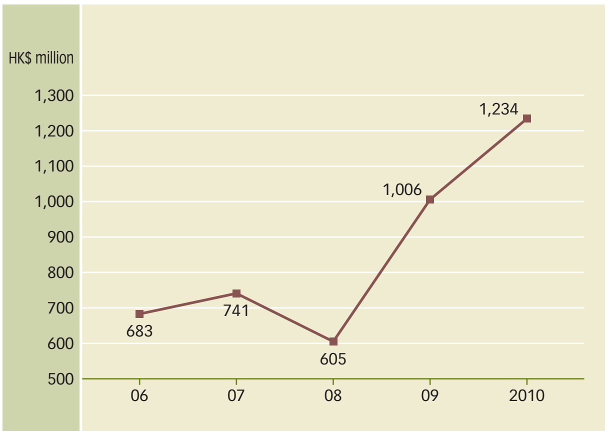


FIGURE 3

Net Interest Income

	2010 HK$'000	2009 HK$'000
Interest income	**1,141,383**	1,338,301
Interest expense	**(170,802)**	(300,594)
Net interest income	**970,581**	1,037,707
Average interest-earning assets	**53,266,677**	60,017,628
Net interest margin	**1.8%**	1.7%
Net interest spread on interest-bearing liabilities[1]	**1.8%**	1.7%

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

net interest spread and net interest margin improved from 1.7% to 1.8%, net interest income for the year declined by 6.5% from HK$1,038 million to HK$971 million because of a reduction in average interest-earning assets of HK$6.8 billion in 2010 **(FIGURE 3)**.

Other Income

Other income rose by 153.4% to HK$588 million in 2010 (2009: HK$232 million). The key item was the mortgage insurance premium earned from the MIP. **(FIGURE 4)**

With the active property turnover that boosted new residential mortgage loans drawn down in the market from HK$199.3 billion in 2009 to HK$324.2 billion in 2010, the Corporation's new business underwritten under the MIP rose from HK$36 billion to HK$41 billion. The amortisation effect of premium receipts underwritten that added to the upfront premium recognised for loan refinancing/prepayment, led to an increase of 148% in the net premiums earned, from HK$171 million to HK$424 million. After reserving the additional provision for outstanding claims of HK$6 million (2009: HK$22 million), the net premiums earned after provision increased by 180.5% from HK$149 million to HK$418 million.

Net gain on disposal of available-for-sale investments was about HK$65 million (2009: HK$5 million), which was attributable mainly to the re-balancing and diversification of investment portfolio.

A dividend income of HK$44 million (2009: HK$42 million) from listed investment securities, which was equivalent to a dividend yield of about 5%, was received in 2010 (2009: 5%). The income was generated from investments in bond fund and real estate investment trust.

An exchange gain of HK$35 million was recorded. It was HK$29 million more than that of 2009 (2009: HK$6 million), primarily due to revaluation of US dollar net exposures.

Early prepayment fees were HK$18 million, HK$2 million lower than that of 2009 (2009: HK$20 million).

Operating Expenses

The Corporation continued to maintain stringent cost controls to contain expenses and improve operating efficiency. Operating expenses recorded an increase of 8.2% over 2009 to HK$171 million, but HK$21 million lower than that projected in the approved budget. Staff costs rose by 5.6% to HK$114 million, which was attributable mainly to further strengthening in our risk management capabilities. Staff costs accounted for 66.7% of total operating expenses, compared to 68.6% in 2009. Premises rental and related costs maintained at HK$14 million. Depreciation charges on assets increased to HK$13 million (2009: HK$11 million). Consultancy fees increased by HK$5 million to HK$12 million, which was attributable mainly to the enhancement of credit risk management capabilities and the legal consultancy fees incurred for new business initiatives **(FIGURE 5)**.

FIGURE 4

Major Source of other Income

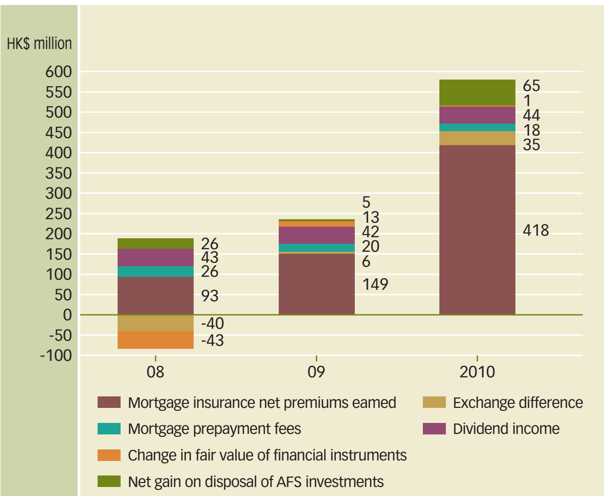


FIGURE 5

Operating Expenses

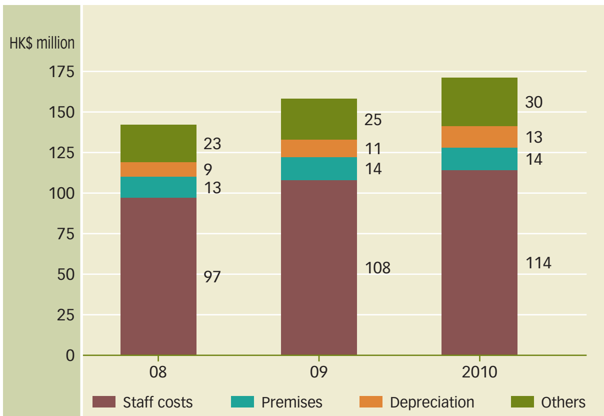
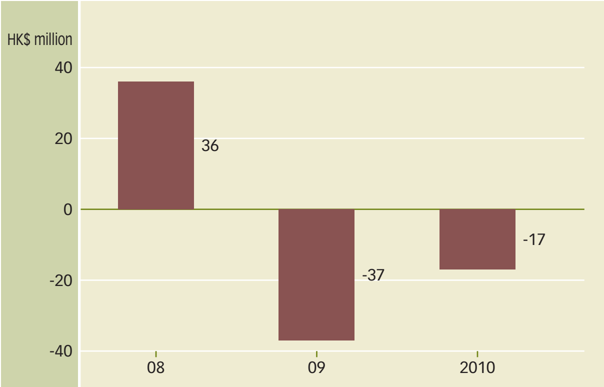


FIGURE 6

(Write-back)/Provisions of Loan Impairment Allowances



Allowance for Loan Impairment

Asset quality remained strong, with the delinquency ratio falling from 0.04% to 0.03%. Collective assessment for loan impairment of HK$17 million was written back in 2010 due to a reduction in loan portfolio of HK$9 billion compared to 2009 and a surge in property price **(FIGURE 6)**.

In respect of the overseas mortgage loan portfolio, asset quality remained healthy as a result of stringent purchasing criteria and prudent risk mitigation. No collective assessment for loan impairment was necessary for 2010 (2009: nil) and no credit loss was recorded so far recorded.

Total allowance for loan impairment accounted for 0.01% of the outstanding principal balance (HK$35.3 billion) of the loan portfolio at the end of 2010, which was similar to the local market level **(FIGURE 7)**. During the year, there were no loans written off (2009: HK$3 million) while the recovery of loans previously written off amounted to HK$4 million (2009: HK$3 million).

FIGURE 7

Ratios

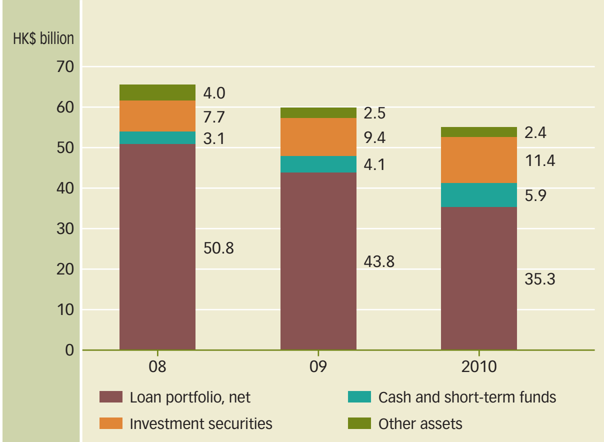
	2010	2009
Delinquency ratio for loan portfolio overdue for more than 90 days	**0.03%**	0.04%
Total allowance for loan impairment as a percentage of the gross loan portfolio	**0.01%**	0.03%

Financial Position

Total assets fell by HK$4.8 billion to HK$55 billion (2009: HK$59.8 billion) **(FIGURE 8)**, mainly due to the reduction of loan portfolio by HK$8.5 billion to HK$35.3 billion. Surplus cash from mortgage receipts was invested in short-term investment securities to bridge the redemption of matured debt securities issued.

FIGURE 8

Asset Deployment



Loan Portfolio

During the year, the Corporation made a purchase of HK$4.7 billion loan assets (2009: HK$8.8 billion), which were all residential mortgage loans in Hong Kong.

Taking account of the prepayment and repayment during the year, the outstanding balance of residential mortgage portfolio and securitised portfolio in Hong Kong stood at HK$18.1 billion and HK$0.7 billion respectively. The Korean residential mortgages recorded a normal runoff of HK$3.5 billion and the outstanding balance stood at HK$11.9 billion. The commercial mortgage portfolio, which was backed by local commercial buildings, maintained at HK$4 billion at the end of 2010, same as that of 2009 **(FIGURE 9)**.

The average prepayment rate of the loan portfolio (including securitised mortgages) increased from 16.3% in 2009 to 24.1% in 2010 because of active property turnover in the current exuberant property market.

FIGURE 9

Loan Portfolio, Net

	2010 HK$'000	2009 HK$'000
Mortgage portfolio		
Residential		
– Hong Kong	**18,081,110**	21,980,141
– Overseas	**11,912,250**	15,441,285
Commercial	**4,000,000**	4,000,000
Securitised portfolio	**717,786**	1,314,685
Non-mortgage portfolio	**549,820**	1,066,616
	35,260,966	43,802,727
Allowance for loan impairment	**(2,029)**	(14,011)
Loan portfolio, net	**35,258,937**	43,788,716

Investment Securities

The Corporation's investment portfolio is mainly made up of bank deposits, short-term commercial papers, certificates of deposit, bonds, yield-based government bond funds and real estate investment trust. The liquid investment portfolio serves as a liquidity buffer to support the Corporation's business operations, enabling it to respond quickly and smoothly to unforeseen liquidity requirements. The Corporation adopts a prudent and low-risk approach in managing its surplus funds and investment activities in accordance with the approved investment guidelines. As at 31 December 2010, the total investment portfolio grew from HK$9.4 billion in 2009 to HK$11.4 billion, which included HK$3.4 billion of available-for-sale investments and HK$8 billion of held-to-maturity investments. The increase in investment portfolio was due to active capital management and surplus cash management arising from businesses activities in 2010. With prudent investment guidelines and asset and liability management, the Corporation did not directly or indirectly hold any sub-prime investment, collateralized debt obligations, high risk European sovereign debts or debt securities issued by the failed financial institutions in its portfolios. As in 2009, there were no impairment losses or provisions against the investment portfolio in 2010.

Debt Securities Issued

In 2010, the Corporation issued a total of HK$8.3 billion of debts in 2010, comprising HK$7.1 billion debts under the DIP and HK$1.2 billion under the MTN. All the non-HK dollar debts issued under the MTN were swapped into HK dollar or US dollar liability using hedging financial derivatives. As at 31 December 2010, the total outstanding balance of the debts issued fell by 12.1%, or HK$5.4 billion, to HK$39.1 billion as compared with 2009. The decline reflected mainly the redemption of HK$13.8 billion debts matured in 2010 to match with the prepayment of mortgage portfolio. Before taking account of the full and partial prepayments, the average life of the loan portfolio was nine years on a contractual basis. While the Corporation issued debts with tenor ranging from one month to 15 years, 87.1% of the Corporation's outstanding debts would mature in one to five years.

Mortgage-backed securities issued

During the year, the Corporation did not issue any mortgage-backed securities ("MBS"). In comparison with 2009, the total outstanding balance of the MBS issued dropped by 25%, or HK$0.5 billion, to HK$1.5 billion, reflecting the redemption of MBS in 2010.

Off-balance Sheet Exposures

Mortgage Insurance

The Corporation operates the MIP business on a risk-sharing basis with approved reinsurers. At the end of 2010, the total risk-in-force was about HK$17.6 billion (2009: HK$14.9 billion), of which HK$2.4 billion (2009: HK$3.3 billion) was ceded to approved reinsurers. The off-balance sheet risk-in-force exposure borne by the Corporation grew 31.4% to HK$15.2 billion in 2010. Out of this exposure, the excess loss of HK$1.9 billion of risk-in-force was hedged through the use of excess-of-loss reinsurance arrangement to reinsure the middle layer risk positions and the Corporation retains a portion of the total risk comprising the first-loss and remote risk portions.

The provision for outstanding claims accounted for 0.46% (2009: 0.56%) of the retained risk-in-force at the end of 2010. The delinquency ratio remained healthy at 0.003%. (2009: 0.003%).

Overseas Businesses

At the end of 2010, the outstanding balance of the Korean mortgage portfolio stood at HK$11.9 billion (2009: HK$15.4 billion). The joint venture in Malaysia, which engages in mortgage guarantee business, recorded a share of profit of HK$2.3 million (2009: HK$1.9 million). The joint venture in the Mainland of China, which engages in mortgage bridging guarantee business, generated a profit of HK$3.3 million (a loss of HK$4.4 million in 2009). The aggregate profit contribution of these businesses amounted to HK$134 million (2009: HK$126 million), or 9.5%, of the Corporation's profit before tax in 2010.

Cash Flow Management

The Corporation generated HK$1.4 billion of cash flow from operating activities before changes in operating assets and liabilities. The cash flow, which was derived mainly from net interest income received, represented an increase of HK$0.2 billion over that of 2009. Repayment of mortgage portfolio was used to finance debt securities redemption and invest in held-to-maturity investment portfolio. Net increase in cash equivalent amounted to HK$0.7 billion in 2010 (2009: HK$1.1 billion).

Capital Management

The Financial Secretary has approved the following capital adequacy framework to account for different levels of risk embedded in the various products. The minimum Capital-to-

Assets Ratio ("CAR") by product reflects a prudent estimate of underlying risks, taking into account any eligible collateral, with some adjustments to reflect the contingent nature of potential losses. **(FIGURE 10)**

The capital base, defined as shareholders' equity excluding hedging reserve plus the allowance for loan impairment under collective assessment, grew by 15.9% from HK$6.3 billion to HK$7.3 billion in 2010 amid the earnings growth. At the end of 2010, the aggregate amount of the Corporation's on-balance sheet assets and off-balance sheet exposure was HK$67.3 billion, which mainly consisted of HK$30.1 billion of risk-weighted mortgage loans, HK$0.9 billion of hire purchase assets, HK$11.4 billion of investment securities, HK$5.9 billion of cash and bank balances, HK$15.2 of billion risk-weighted mortgage insurance exposure, HK$2.6 billion of replacement costs and potential future credit exposure of derivative contracts, HK$0.1 billion of risk-weighted guarantee exposure under the MBS programmes and HK$1.1 billion of other assets. At the end of 2010, there was no outstanding exposure for the newly launched guarantee schemes, PLGS and SFGS. The CAR stood at a healthy level of 10.8% (2009: 9.5%), well above the minimum level of 5% stipulated by the Financial Secretary.

Dividend

At the Annual General Meeting held on 12 April 2011, Shareholders, having considered the exceptional financial performance of the Corporation and the capital requirement for launch of new businesses in 2011, approved a final dividend of HK$0.175 (2009: HK$0.25) per share, totalling HK$350 million (2009: HK$500 million), representing a 28.4% of the profit attributable to shareholders.

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") guaranteed by the Corporation	2% of MBS portfolio (based on outstanding principal balance plus accrued interest)
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
Non-residential mortgage loans	8% of the non-residential mortgage loan portfolio
Non-mortgage loans	8% of the non-mortgage loan portfolio
Overseas residential mortgage loans	The capital requirement applicable to the jurisdiction in which the overseas residential property is situated to adjust for the 5% requirement on regular mortgage loan portfolio
Mortgage Insurance Programme ("MIP")	0% of risk-in-force value of exposure covered by the Approved Reinsurers under reinsurance arrangement with significant credit risk transfer 5% of risk-in-force value of exposure not covered, or covered by the Approved Reinsurers under reinsurance arrangement without significant credit risk transfer
Guarantee on premium loan under Premium Loan Guarantee Scheme ("PLGS")	5% of guarantee exposure
Guarantee under SME Financing Guarantee Programme ("SFGS")	6% of guarantee exposure where the aggregate exposure to a single obligor does not exceed HK$10 million 8% of guarantee exposure where the aggregate exposure to a single obligor exceeds HK$10 million