Business Overview

2006 was a challenging yet fruitful year for the HKMC. A major turning point was witnessed in the business development of the Corporation. With the guidance and approval of the Board, the Corporation has progressively expanded the scope of its core businesses in a number of dimensions. Against this background, the Corporation has set a new record for its profit after tax. In the long run, this strategic direction of business broadening will enable the Corporation to be in an even better position to fulfil its core objectives of maintaining banking stability, promoting homeownership and facilitating the development of the local debt market.

Performance Highlights

In line with the strategic direction set by the Board, the Corporation is progressively expanding the scope of its asset acquisition beyond residential mortgage loans and the Hong Kong market. This strategic move has helped to broaden the scope of the Corporation's businesses and enable it to be in an even better position to contribute towards maintaining banking stability, promoting homeownership and facilitating the development of the local debt market.

The major achievements of the Corporation include:

- Purchase of a total of HK$6.4 billion of financial assets, including HK$1 billion of residential mortgage loans, HK$4 billion of non-residential mortgage loans and HK$1.4 billion of non-mortgage assets;
- Providing mortgage insurance coverage for newly originated mortgage loans totalling HK$9.2 billion, achieving a market penetration of 13.3%;
- Issuance of HK$13.3 billion in debt securities and HK$2 billion in mortgage-backed securities ("MBS"), maintaining its position for the sixth year as the most active corporate issuer in the Hong Kong dollar debt market;
- Maintaining excellent asset quality, with a combined delinquency (90-day above) and rescheduled loan ratio of 0.03% for the mortgage insurance portfolio, 0.34% for the residential mortgage portfolio (compared to the industry average of 0.46%), and 0.29% across all asset classes;

- Upgrade of the HKMC's long-term credit ratings making it the first triple-A rated institution in Hong Kong – Aaa/AA for local currency and Aa1/AA for foreign currency debt securities by Moody's Investors Service, Inc. ("Moody's") and Standard & Poor's ("S&P's") respectively.

These achievements propelled the Corporation to achieve satisfactory financial results in 2006:

- Profit after tax of HK$682.7 million, which is HK$81.4 million or 13.5% higher than that in 2005;
- Low funding costs from new debt issuances has helped to maintain the net interest spread at 1.2%, the same as in 2005;
- Return on assets of 1.6%, an improvement from 1.3% in 2005;
- Return on shareholder's equity of 13.9%, compared to 13.6% in 2005;
- Capital-to-assets ratio remained strong at 11.2%, well above the minimum requirement of 5%;
- Cost-to-income ratio of 13.5%, significantly lower than the banking industry average of around 42.7%.

Operational Highlights

During the year, the Corporation made good progress in developing and broadening the dimension of its core businesses:

Asset Acquisition

- As a pioneer in new mortgage product development, the Corporation launched in March 2006 the Composite-rate ("C-rate") mortgage product and received positive responses from homebuyers. The C-rate has seen an adjustment from the peak of 3.39% in May to 2.86% in December, reflecting the abundant liquidity in the banking system and a lower cost of funds for the banks;
- Apart from purchasing residential mortgage loan portfolios valued at HK$1 billion, the HKMC has started to acquire non-residential mortgage portfolio (HK$ 4 billion) and non-mortgage assets (HK$ 1.4 billion) in 2006.

Mortgage Insurance

- The Corporation continued with its role to develop new products under the Mortgage Insurance Programme ("MIP"). In February 2006, the Corporation extended the MIP to cover mortgages secured by village houses with loan-to-value ("LTV") ratio up to 85%. The move has generated good interest from potential homebuyers of village house properties;
- To further broaden the utilisation of the MIP and increase its attractiveness, the Corporation made a move towards risk-based pricing in May 2006 by launching the Risk-Based Pricing Scheme ("RBPS") and Loyalty Discount Scheme ("LDS"). The RBPS offers premium discount of up to 20% for loans with LTV ratio of 85% or below while the LDS offers premium discount of 15% to repeat MIP users. These initiatives have attracted good responses from the general public;

- A 24-hour web-based Enquiry of MIP Application Approval Status ("EAS") launched in October 2006 provides MIP applicants with up-to-date information about the status of their loan applications via access to the HKMC's website. The new service, which provides greater convenience for homebuyers to check the latest status of their MIP applications, has received very encouraging feedback from general public;
- The Corporation provided full support in MIP training for frontline staff and credit personnel of MIP participating banks as an integral part of joint partnership in the promotion of MIP businesses;
- The market penetration of the MIP was 13% in 2006;
- The Corporation maintained the processing efficiency of 1-day turnaround time for MIP applications in general.

Fund-raising

- For the sixth year, the Corporation was the most active corporate issuer in the Hong Kong dollar debt market;
- A pioneer issue of HK$100 million 2-year Composite Interest Rate Notes under the Debt Issuance Programme;
- Issuance of retail bonds for a total of HK$1.3 billion plus the first-ever Hong Kong dollar 10-year zero coupon bonds under the Retail Bond Issuance Programme;
- Issuance of a total of HK$13.3 billion of plain vanilla and structured corporate debts with tenors ranging from 3 months to 15 years in the institutional and retail markets to support mortgage purchase activities and redemption of maturing debts.

Mortgage-backed Securitisation

- Issuance of a new series of HK$2 billion MBS, bringing the total MBS issuance amount since 1999 to HK$13.2 billion. The series was the first partially guaranteed MBS with senior tranche rated "Aaa/AAA" and subordinated tranche rated "Aaa/AA".

Mortgage and Business Operations

- Installation of customer service hotline and implementation of full system solution to support the continued growth in the loan servicing business established in 2005. The improved operational mode helped our business partners to leverage on our expertise and infrastructure;
- Development of a new operational model by streamlining the servicing requirements for our Approved Servicers whilst allowing full flexibility in managing servicing and asset quality. Full implementation will be completed in 2007;
- Implementation of the second phase of integration between the back-end treasury system and SWIFTNet, allowing straight-through processing of treasury transactions in an efficient and effective manner.

Mortgage Market Overview

General Economic Conditions

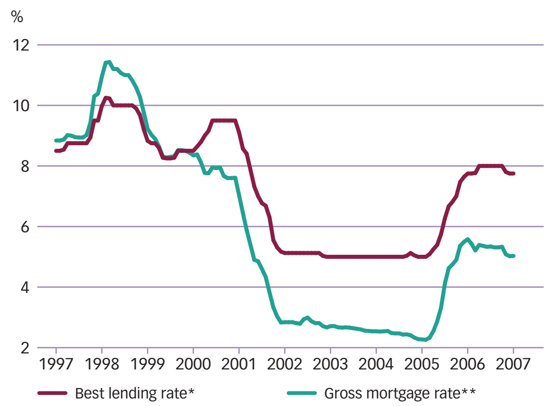
The Hong Kong economy saw robust growth in 2006. GDP grew significantly by 6.8% for the year of 2006. In the fourth quarter of 2006, unemployment rate went down to the lowest level of 4.4% since mid-2001. The number of bankruptcy cases has remained relatively low since the peak in 2002. Household income improved modestly in 2006 while the buoyant stock market facilitated considerable growth in investment earnings and accumulation of wealth.

Interest Rate Environment

Since the first quarter of 2005, the best lending rates of banks in Hong Kong rose nine times by 2.25% altogether and stabilised at 8%-8.25% in April 2006. The interest rates did not follow the rate hike of the US in May and in June, and eventually eased slightly to 7.75%-8% in November 2006 due to local liquidity condition. During the same period, the gross mortgage rate rose from 2.2% to 5%-5.5% (Figure 1).

FIGURE 1

Best Lending Rate and Gross Mortgage Rate



* Best lending rate refers to the rate quoted by the HSBC

** Compiled by the HKMC based on HKMA statistics

Source: HKMA

Although the increase in interest rate has dampened the buying interests of the homebuyers (and also investors), the eventual stabilisation of interest rate saw an end to a consolidation phase in the housing market.

Property Market

Due to the abundant supply in the housing market, together with homebuyers' anticipation of interest rate cut following the expected ending of rate hike cycle in US, housing prices and residential property transactions were sluggish during 2006.

According to the Private Domestic Price Indices ("PDPI") published by the Rating and Valuation Department, the overall housing prices for 2006 increased marginally by 0.76% over the previous year (Figure 2).

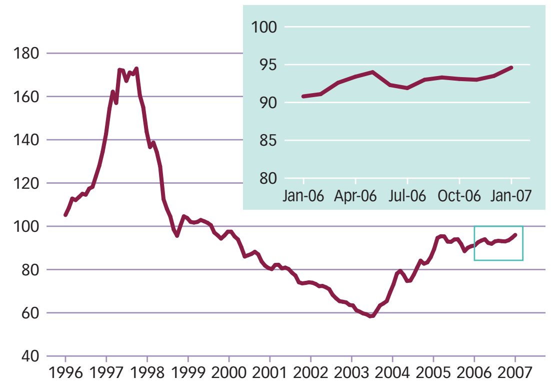
Launch of new residential development continued to be slack in the first half of 2006 as developers were reluctant to lower selling prices in a slow market and chose to hold back supply, until recovery of market conditions. As a result, notable decline by about 20% and 26% in the volume and value of residential property transaction respectively, as reported by the Land Registry, was recorded for 2006 despite regained momentum in the primary market in the second half of the year (Figure 3).

Mortgage Market

Keen competition for mortgage loans amongst banks continued in 2006. The statistics published by the HKMA revealed that the total outstanding value of mortgage loans on average dropped by 2% over the previous year to around HK$595 billion in 2006. In fact, the overall market size has remained fairly stable in recent years. With the sluggish property market, mortgage loan origination also declined by 19.4% to HK$115 billion over the previous year. To compensate for the shrinkage in mortgage portfolio due to fast mortgage loan prepayments, banks competed aggressively for new mortgage business (Figure 4).

FIGURE 2

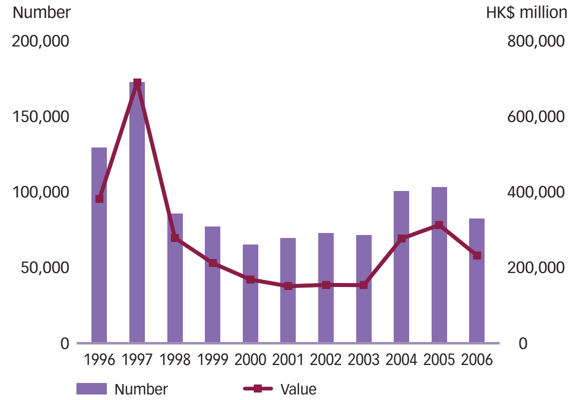
Private Domestic Price Index (1999=100)



Source: Rating and Valuation Department

FIGURE 3

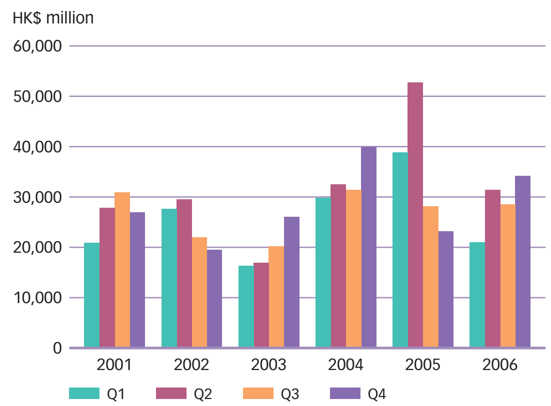
Agreements of Sale and Purchase of Residential Building Units



Source: Land Registry

FIGURE 4

New Residential Mortgage Loans Made



Source: HKMA

In February, a major bank announced a reduction in their mortgage interest rate to Prime rate (7.75%) less 2.75%, and other banks followed suit to match the lowest prevailing rate in the market. In July, another major bank further lowered their mortgage interest rate, leading to another round of rate cuts. As a result, according to the HKMA's Monthly Residential Mortgage Survey, more than around 60% of the newly approved mortgage loans had been priced at more than 2.5% below the Prime rate since the second quarter of 2006 as compared to its single-digit share in the fourth quarter of 2005 (Figure 5).

Apart from cutting mortgage rates, many banks also offered HIBOR-linked or Composite Rate-based mortgage loans to attract homebuyers.

Banking Sector Exposure

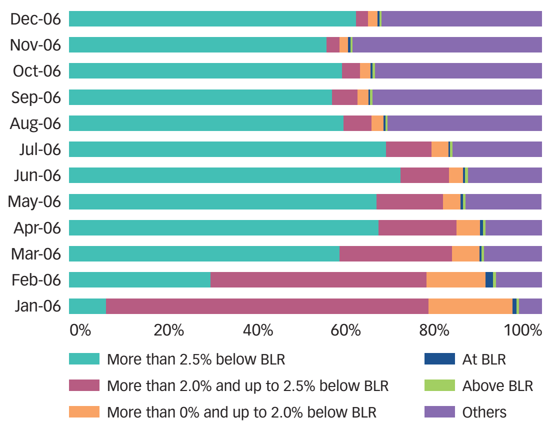
For the banking sector as a whole, mortgage loans for private residential properties accounted for 27.1% of the total loans for use in Hong Kong as at December 2006. Taking into account loans for property development and investment, property-related loans amounted to HK$1,017 billion or 51.5% of the total loan book of the banks. Although most banks in Hong Kong have a strong capital base, the high exposure to property-related lending indicates that a sharp downturn in the property market could have a significant impact on the overall stability of the banking system (Figure 6).

Asset Acquisition

The Corporation has made successful efforts in diversifying the sources of its asset acquisition and hence its revenue streams. In the early years of its establishment, the Corporation derived the majority of its revenue from its mortgage portfolios. For 2006, acquisition of mortgage loans from banks remained at a level lower than previous years. This was primarily due to three factors – abundant liquidity in the banking sector, notable shrinkage in the volume of mortgage loan originations and good quality of mortgage loans. Throughout 2006, liquidity in the market remained high as demonstrated by the loan-to-deposit ratio of 51.8% as at December 2006 (Figure 7). Secondly, mortgage loan origination and residential property transactions remained sluggish throughout the year. The market's total outstanding balance of mortgage loans and the volume of mortgage loan origination dropped by 2% and 19.4% respectively, compared with the

FIGURE 5

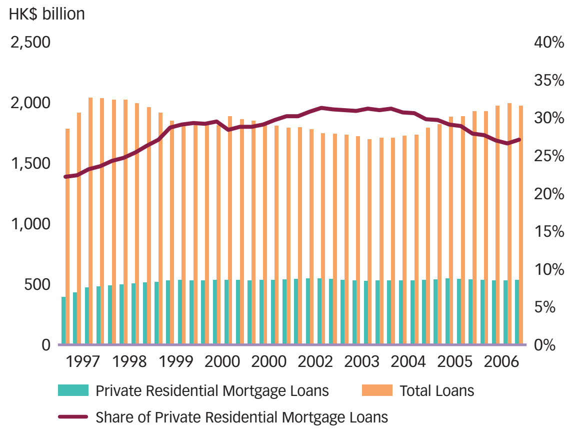
Pricing of New Mortgage Loans Approved in 2006



BLR: Best Lending Rate
Source: HKMA

FIGURE 6

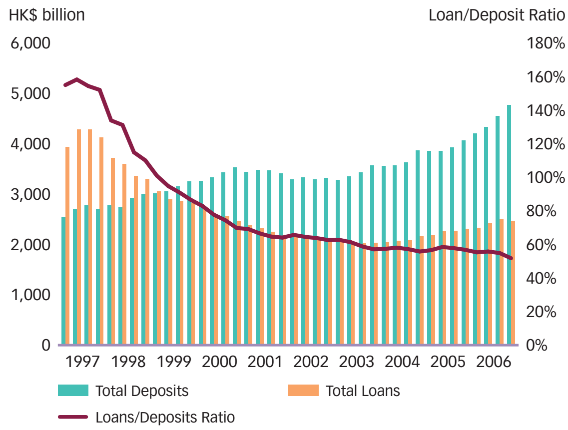
Total Loans and Private Residential Mortgage Loans of All Authorised Institutions



Source: HKMA

FIGURE 7

Total Loans and Deposits



Source: HKMA

previous year. In addition, the performance of mortgage loans has benefited from steady economic growth. The industry delinquency ratio for mortgage loans (overdue for more than 3 months) edged up slightly from 0.19% in December 2005 to 0.20% in December 2006 and against this background, the banks generally prefer to hold on to mortgage assets on their books (Figure 8).

With this change in the market conditions, the Corporation adopted a three-pronged strategy in diversifying the sources of asset acquisition. The first is new product development to provide consumers with a wider choice. In March 2006, the Corporation pioneered with the introduction of C-rate mortgage product. The C-rate mortgage product allows banks to better manage their interest rate risk by reducing the mismatch between their cost of funds and interest income from mortgage portfolio. The product also provides borrowers with a less volatile mortgage interest rate.

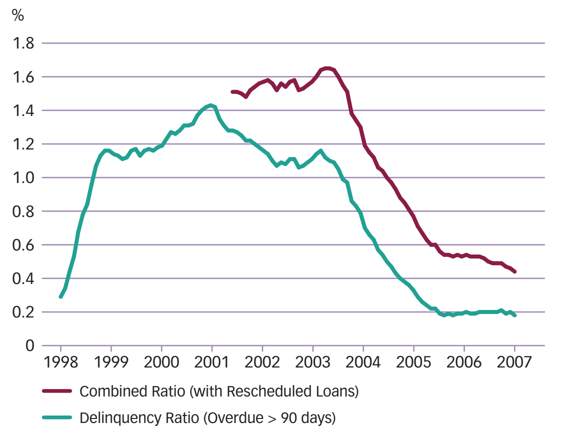
Secondly, with the approval of the Board, the Corporation successfully diversified its asset acquisition to cover non-mortgage assets and mortgage loans secured on non-residential properties. Altogether HK$1.4 billion of non-mortgage assets and HK$4 billion of mortgage loans secured on non-residential properties were purchased in 2006. Such diversifications served to widen the sources of asset acquisition for the Corporation and enabled it to play a more effective role in providing liquidity to the banks.

Consultancy Services

Finally, over the years the HKMC has built up a strong reputation as a premier mortgage corporation in Asia. The Corporation has been sharing its knowhow with various mortgage corporations and financial institutions in the region. We are also invited to provide consultancy services in areas such as development of a secondary mortgage market, mortgage-backed securitisation, mortgage insurance, process flow management and business operations. At the same time, we have been approached by various renowned financial institutions outside Hong Kong to explore potential business opportunities in the acquisition of mortgage assets and the provision of mortgage insurance. Such business opportunities entail a comprehensive study of the market conditions and risk management in the mortgage markets in those overseas countries. Through consultancy and training engagements,

FIGURE 8

Delinquency ratio of Residential Mortgage Loans



Source: HKMA

the Corporation will be able to gain an invaluable insight into the mortgage and property markets of these countries, including China in particular. The Corporation will thus be in a good position to evaluate the feasibility and viability of business opportunities as they arise.

Strategic Positioning and Long-term Vision

With the approval of the Board of Directors, the Corporation commissioned a management consultancy firm to conduct an independent strategic review of the Corporation's businesses in 2006, with the aim of assisting the Corporation in developing a long-term vision and business direction for the future. The consultancy firm observed that the banking system is awash with liquidity and the interest spread on mortgage loans has been narrowing significantly, making mortgage purchase more difficult.

After detailed research and consultation with major stakeholders, the consultancy firm concluded that there is an ongoing need for the HKMC to be a liquidity provider to the banking system to contribute to banking and financial stability. The Corporation will have a critical role to perform – in adverse circumstances rather than in "fair weather".

The Board of Directors accepted the assessment that without substantial asset acquisition by the Corporation, there would be little room for the Corporation to remain a viable entity and continue to provide liquidity to banks when needed and to promote homeownership and debt market development. The Corporation needs to expand its business horizons in light of changes in market conditions. After the Board's endorsement of the consultant's recommendations on the strategic positioning and future development of the Corporation's businesses, the Corporation has started to broaden its businesses gradually through exploring the purchase of non-mortgage assets in Hong Kong and expanding its businesses activities in other countries.

Mortgage Insurance Programme

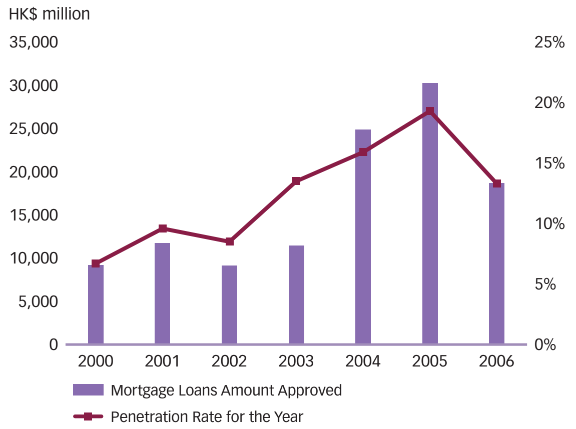
The MIP has demonstrated its contribution in assisting potential homebuyers to overcome the hurdle of requiring a substantial down payment for the purchase of a property. From the perspective of the banking industry as a whole, the programme allows the banks to engage in higher LTV lending without incurring additional credit risk and jeopardising the stability of the banking system. In all, it creates a win-win situation for both the homebuyers and the banks.

Since the inception of the MIP in March 1999, the programme has gained increasing public acceptance and now plays an instrumental role in promoting home ownership in Hong Kong. For the year 2006 as a whole, the HKMC received 11,824 applications with an aggregate mortgage loan amount of HK$24 billion. About 86 per cent of MIP loans received are for secondary market properties, demonstrating that the MIP is particularly instrumental in promoting the liquidity of the secondary market. Notwithstanding the interest rate hike between March 2005 and March 2006, the volume of loans drawn down in 2006 amounted to HK$9.2 billion and the market penetration rate of approved loans was 13.3% (Figure 9).

The Corporation has taken the following major steps in 2006 to further enhance the product features and public acceptance of the MIP:

FIGURE 9

Mortgage Loans Amount Approved and Penetration Rate* of MIP



* Penetration Rate = Mortgage Loan Amount approved under MIP/Total Mortgage Loan amounted approved in the market based on HKMA's Monthly Residential Mortgage Survey

Sources: HKMA and HKMC

- Expansion of coverage to village houses

  The increasing popularity of the programme is achieved primarily through on-going product innovation, coupled with continued fine-tuning of the programme's eligibility criteria in response to changes in market demand.

  At the request of the banks, and with the support from the Approved Reinsurers, the Corporation announced in February 2006 that the coverage for village houses will be extended up to LTV ratio of 85% with a maximum loan amount of HK$5 million. Some banks immediately offered mortgage loans for village house homebuyers with improved interest rates. The extension provides potential buyers of village house properties with more flexibility in down payment.

- Premium Discount Schemes

  The HKMC developed an in-house credit scoring model in May 2006 as a tool for measuring the relative credit standing of various MIP borrowers. The model makes use of credit differentiation to streamline the underwriting process and represents a first attempt to implement a Risk-Based Pricing Scheme that offers premium discount. The maximum premium discount under the scheme for a mortgage loan with LTV ratio up to 85% could be as high as 20% of the gross premium amount.

  In addition, the Corporation has also developed a Loyalty Discount Scheme to encourage previous MIP users to continue to utilise mortgage insurance in the future. Subject to fulfillment of owner occupancy requirement and punctual repayment record for the previous MIP loan, borrowers can attain a maximum discount rate of up to 15% of gross premium.

- Web-based Enquiry of MIP Application Approval Status

  In October 2006 the HKMC launched an innovative web-based system for status enquiry on MIP applications. This system enables the homebuyers to obtain the most up-to-date status on their applications submitted through the MIP participating banks. In addition, a hotline service is also provided for homebuyers to make more detailed enquiries if necessary. These steps are designed to make the MIP more user-friendly and accessible to potential users.

- Training and Marketing

  The Corporation has always kept participating banks closely informed of all new developments under the MIP and sought their feedback prior to launch. We have also proactively invited banks and other market players such as estate agents and referral companies to send their staff to attend seminars organised by the Corporation. These seminars serve the purpose of providing thorough training on product features and eligibility criteria so that the attendees are sufficiently equipped to market the new products to their customers.

Funding

Riding on the abundant liquidity in the Hong Kong dollar market and pursuing a pro-active funding strategy, the Corporation has continued to be the most active Hong Kong Dollar corporate issuer for the sixth year. In 2006, our 50 debt issues for a total amount of HK$13.3 billion financed our loan purchase activities and redemption of maturing debts. At the end of 2006, the Corporation had a total outstanding debt amounting to HK$28.9 billion.

The HKMC is committed to developing the local debt market through regular debt issuance as well as introduction of new debt products. As one of Hong Kong's most active bond issuers, the HKMC will continue to issue debts in both institutional and retail markets. This will not only help to broaden the Corporation's funding base but also provide institutional and retail investors with high quality debt instruments to satisfy their need for portfolio diversification and yield enhancement.

The Corporation has two debt issuance programmes which allow the issuance of debt securities in an efficient and effective manner.

Debt Issuance Programme

The Debt Issuance Programme ("DIP") is the HKMC's major platform for raising Hong Kong dollar funds. The DIP was established in July 1998, targeting institutional investors in the Hong Kong dollar debt market. It was set up with an initial programme size of HK$20 billion which was subsequently increased to HK$40 billion in 2003. The structure of the DIP is similar to that of a Euro Medium Term Notes Programme, under which plain vanilla and structured debts and transferable loan certificates can be issued in a flexible and efficient manner. In response to investor demand for short-term and high quality debt issue, the HKMC commenced to issue short-term discount notes under the DIP with tenors ranging from 3 months to 1 year. During 2006, the Corporation drew down altogether 49 DIP debt issues for a total amount of HK$12.05 billion. At the end of 2006, the total outstanding amount of DIP debt securities was HK$23.7 billion. Going forward, the HKMC may expand its fund-raising capabilities to international markets to cope with the new overseas business initiatives.

Retail Bond Issuance Programme

The Corporation successfully pioneered a new offering mechanism for the retail bond market in Hong Kong in November 2001. To further spur the solid development of the retail bond market, the Corporation established a HK$20 billion Retail Bond Issuance Programme ("RBIP") and made a debut issue in June 2004. Under this programme, banks acting as Placing Banks use their retail branch networks, telephone and electronic banking facilities to place debt securities issued by the Corporation to retail investors. To ensure that the bonds held by retail investors can be sold at any time before maturity, the Placing Banks for our retail bonds have committed to making firm bid prices for the bonds in the secondary market.

The retail bond issue launched by the Corporation in 2006 attracted participation by 17 Placing Banks. The Placing Banks together constituted a network of as many as 840 branches to accept retail investors' applications. An aggregate amount of HK$1,291 million was raised through two Hong Kong dollar tranches and one US dollar tranche in this issue. This was the first issuance of Hong Kong dollar zero coupon bonds in the Hong Kong retail bond market and also the first time the HKMC issued retails bonds with a ten-year tenor. The retail bond issue has brought the total amount of HKMC's retail bonds issued to HK$12.3 billion since 2001. At the end of 2006, the total outstanding amount of retail bonds issued by the Corporation stood at HK$5.2 billion.

Credit Ratings

The Corporation's ability to attract investors to invest in our debt securities is underpinned by strong credit ratings accorded by Moody's and S&P's.

On 25 May 2006, Moody's upgraded the HKMC's long-term foreign currency rating from "A1" to "Aa3" with stable outlook, along with the revision of foreign currency country ceilings of Hong Kong.

On 27 July 2006, in line with the upgrade of the credit ratings of the Hong Kong SAR Government, S&P's upgraded the long-term local and foreign currency ratings of the Corporation from "AA-" to "AA" and reaffirmed the stable outlook.

Subsequently, on 30 October 2006, Moody's upgraded the long-term local currency rating from "Aa3" to "Aaa" with stable outlook and also upgraded foreign currency rating from "Aa3" to "Aa1" with positive outlook, following the revision of Moody's rating methodology for government-related financial institutions. The HKMC made history as the first triple-A rated institution in Hong Kong.

Credit Ratings of the HKMC

Credit Ratings	2006	2005
Moody's		
Long-term	**Aaa/Aa1**	Aa3/Aa3
Short-term	**P-1/P-1**	P-1/P-1
Standard & Poor's		
Long-term	**AA/AA**	AA-/AA-
Short-term	**A-1+/A-1+**	A-1+/A-1+

Issuer credit rating for local currency and foreign currency respectively

The credit rating agencies have made very positive comments on the credit standing of the HKMC. The following comments are extracts from their credit rating reports after the annual surveillance conducted by the credit rating agencies in May 2006:

Moody's

"The baseline credit assessment of 6 (on a scale of 1 to 21, where 1 represents lowest credit risk) is underpinned by HKMC's unique franchise in Hong Kong, flexible business model, professional and prudent risk management, solid financial fundamentals and strong management team."

"HKMC's asset-liability management is well developed within the constraints of the local markets in terms of the availability of tools and long-term funding. Its ability to assess and manage risk has resulted in levels well within the Corporation's own guidelines and, in some cases, superior to some of its larger international peers."

"Over years, HKMC had demonstrated a strong ability to secure funding, even when liquidity in the system shrank during unexpected circumstances."

"HKMC adopted a Corporate Governance Code that is benchmarked against the Code on Corporate Governance Practices issued by The Stock Exchange of Hong Kong Ltd for listed companies and the Hong Kong Insurance Authority's corporate governance guidelines so as to ensure staff adheres to the best practices in corporate governance. Moody's is confident that HKMC will continue to function at the highest possible international standard."

S&P's

"The ratings reflect HKMC's solid capital base, good asset quality, satisfactory profitability, well-managed liquidity, and strong financial flexibility."

"HKMC's profitability is satisfactory and its asset quality is very good."

"HKMC's liquidity is well managed. The Corporation maintains a reasonably good level of liquid assets in the form of marketable debt securities, and cash and bank deposits maturing within 12 months."

"Outlook: The stable outlook reflects the likelihood that HKMC's strong financial profile and implicit support from the government of the HKSAR will continue to bolster its credit profile. The Corporation is likely to maintain a satisfactory level of profitability through business diversification in a favorable operating economic environment… HKMC's risk management is expected to remain prudent and support satisfactory earning."

Mortgage-backed Securitisation

The Corporation has established two mortgage-backed securitisation programmes for issuance of MBS in an efficient and effective manner. These two programmes, the Guaranteed Mortgage-Backed Pass-Through Securitisation Programme and the Bauhinia Mortgage-Backed Securitisation Programme, were the first-ever securitisation programmes set up in the Hong Kong debt market.

MBS are powerful financial instruments that can channel long-term funding from the debt market to supplement the need for the long-term financing generated by mortgage loans. Banks and financial institutions can make use of MBS to manage risks inherent in mortgage loans such as credit, liquidity, interest rate and asset liability maturity mismatch. A deep and liquid MBS market can help to enhance the development of an efficient secondary mortgage market and further promote Hong Kong as an international financial centre.

Guaranteed Mortgage-backed Pass-through Securitisation Programme

This first MBS securitisation programme of the HKMC was established in October 1999 and targeted banks that did not just want to offload mortgage loans but also wished to enjoy the benefits of holding MBS guaranteed by the HKMC.

The back-to-back structure under this programme allows the HKMC to acquire mortgage loans from a bank and then sell the mortgage loans directly to a bankruptcy remote special purpose entity ("SPE"). The SPE in turn issues MBS to the bank as investor of the security. Through this back-to-back exercise, the bank can convert illiquid mortgage loans into liquid MBS. Furthermore, as far as capital adequacy requirement is concerned, the MBS guaranteed by the HKMC are assigned a 20% risk asset weighting under the Banking Ordinance as opposed to 50% for mortgage loans, thereby allowing the banks to utilise their capital more efficiently. Since the inception of the programme, four series of MBS for a total amount of HK$2.8 billion have been issued.

Bauhinia Mortgage-backed Securitisation Programme

The Bauhinia Mortgage-Backed Securitisation Programme established in December 2001 is a US$3 billion multi-currency mortgage-backed securitisation programme. The programme provides a convenient, flexible and cost-efficient platform to the HKMC for the issuance of MBS with various product structures, credit enhancement and distribution methods. MBS issued under the Bauhinia Mortgage-Backed Securitisation Programme have the trading and settlement characteristics of a eurobond. Trading of the MBS in the secondary market is therefore made more convenient and efficient.

Since the inception of the Bauhinia Mortgage-Backed Securitisation Programme, the Corporation has successfully securitised HK$10.4 billion of mortgage loans through five public issues and one private placement issue. The debut Bauhinia MBS issue with a size of HK$2 billion was done in March 2002. The second issue of HK$3 billion done in November 2003 was the largest ever Hong Kong dollar denominated residential MBS. The third public issue of HK$2 billion, split into two portions for institutional and retail investors respectively, was done in November 2004. This was the first time in the whole of Asia that retail investors were given the opportunity to invest in MBS. The fourth MBS issue of HK$1 billion was done in November 2005. The fifth public issue of HK$2 billion, split into three senior tranches rated "Aaa/AAA" and one subordinated tranche rated "Aaa/AA", was done in November 2006. This was the first-ever partially guaranteed MBS under the Bauhinia Programme.

Risk Management

Prudent risk management is a fundamental and integral part of the HKMC's operations and one of the crucial factors in sustaining the growth in corporate earnings and profits. Over the years, the Corporation has made continual refinements and now possesses a robust and time-tested risk management framework as described below. The five major risk areas facing the HKMC comprise credit risk, interest rate risk, liquidity risk, currency risk and operational risk.

a) Credit Risk

Credit risk is the primary risk exposure for the HKMC. It represents the risk of default of loan borrowers or other counterparties and that amounts owed cannot be fully recovered.

The credit quality of the HKMC's retained asset portfolio has all along remained consistently good, even with the steady growth of the portfolio over the past few years. The delinquency ratio for the retained residential mortgage portfolio as a whole was 0.23% as at December 2006, compared with 0.22% as at December 2005. If rescheduled loans are included, the combined ratio of 0.34% compared favourably with the combined ratio of 0.46% for the banking industry as a whole. This bears testimony to our strong emphasis on combining loan growth with prudent risk management.

At the heart of the credit risk management framework are two committees, the Credit Committee and the Transaction Approval Committee.

Credit Committee

The Credit Committee is vested with the task of setting the Corporation's overall credit policies and standards, notably for asset acquisition and mortgage insurance, which are benchmarked against those adopted by the banking and insurance industries. The Committee makes recommendations to the Board for the approval of such policies as appropriate. It oversees the exercise of approval authority to accept applications to become Approved Sellers/Servicers for sale and servicing of financial assets and Approved Reinsurers under the MIP, the setting and monitoring of risk exposure limits for business counterparties and the making of recommendations to Senior Management on appropriate follow-up actions.

Transaction Approval Committee

The Transaction Approval Committee is responsible for assessing the credit risks and the terms and conditions for new products under the areas of asset acquisition, mortgage insurance and MBS, taking into consideration the latest market conditions and business strategies. The Committee also conducts in-depth analyses of potential transactions for internal approval, prior to their submission to Executive Director for authorisation where necessary.

Both Committees are chaired by the CEO and its members include the Senior Vice President (Operations), the Senior Vice President (Finance), the General Counsel and senior staff of the Operations Division and the Finance Division.

To address credit risk effectively, the Corporation adheres to a four-pronged approach to maintain the quality of its asset and MIP portfolios:

- Careful selection of Approved Sellers;
- Prudent asset purchasing criteria and insurance eligibility criteria;
- Effective due diligence review process; and
- Adequate protection for higher-risk mortgages or transactions.

Careful Selection of Approved Sellers

The HKMC conducts a detailed due diligence assessment of a potential asset seller or servicer prior to its appointment as an Approved Seller/Servicer. The assessment covers a broad range of credit-related matters, focusing primarily on the seller's underwriting policies, historical delinquency experiences and asset servicing capabilities. Once approved, the Approved Seller/Servicer is subject to periodic reviews.

Prudent Asset Purchasing and Insurance Eligibility Criteria

The HKMC adopts prudent asset purchasing criteria for its asset acquisition. The obligors' repayment ability is also carefully evaluated by using key indicators such as debt-to-income ratio and exposure to outside debts. Other relevant criteria are in line with best market practices adopted by the banking industry. For mortgage insurance, prudent eligibility criteria and underwriting guidelines are implemented strictly in line with the agreement reached with the Approved Reinsurers on different MIP products.

Effective Due Diligence Process

As an integral part of the risk management framework, the HKMC conducts due diligence review on a sample of assets to be acquired or acquired both before and after their acquisition to ensure compliance with the Corporation's asset purchasing criteria.

Adequate protection for higher-risk mortgages

For products involving a higher degree of credit risk such as top-up loans, the HKMC has established credit enhancement arrangements such as repurchase warranties or reserve funds in order to mitigate the additional credit risk associated with these loans.

b) Interest Rate Risk

Net interest income is the predominant source of the Corporation's earnings. It represents the excess of interest income from the HKMC's mortgage assets, non-mortgage assets, cash and debt investments over its interest expenses on short and long-term borrowings. Interest rate risk arises when changes in market interest rates affect the income and expenses derived from the asset-liability portfolio.

The primary objective of interest rate management is therefore to limit the potential adverse effects arising from interest rate movements on interest income/expenses and, at the same time, achieve a stable growth in earnings. The interest rate risks faced by the Corporation are threefold.

Interest Rate Mismatch Risk

Interest rate mismatch risk is the most significant type of interest rate risk affecting the HKMC's net interest income. It arises mainly as a result of the differences in the timing of interest rate re-pricing for the Corporation's interest-earning assets and interest-bearing liabilities. Interest rate mismatch risk is most evident in the loan portfolio where the majority of the loans are floating-rate loans benchmarked against the Prime rate, Hong Kong Interbank Offered Rate ("HIBOR") or Composite Interest Rate ("C-rate"), whilst the majority of our liabilities are fixed-rate debt securities.

The Corporation makes prudent use of a range of financial instruments such as interest rate swaps, interest rate swaptions, 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 arising from the issuance of debt securities 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 Corporation also makes use of duration gap as an indicator to monitor and manage interest rate mismatch risk. Duration gap measures the difference in interest rate re-pricing intervals between assets and liabilities. The wider the duration gap, the higher is the interest rate mismatch risk, and vice versa. A positive duration gap means that the duration of assets is longer than that of the liabilities and represents a greater risk exposure to rising interest rates. On the other hand, a negative duration gap indicates a greater risk exposure to declining interest rates. Depending on the prevailing interest rate outlook and market conditions, the Corporation proactively re-balances the duration gap of our asset-liability portfolio under the guidance and supervision of the Asset and Liability Committee ("ALCO"). A cap of three months for the duration gap has been set by ALCO to limit the interest rate mismatch risk. Throughout 2006, the actual duration gap has been kept within one and a half months, indicating that the Corporation is handling interest rate mismatch risk in a very prudent manner.

Basis Risk

Basis risk represents the difference in basis of the Corporation's interest-earning assets that are Prime-based and interest-bearing liabilities that are HIBOR-based. There are limited financial instruments currently available in the market to hedge the Prime-HIBOR basis risk fully. In general, basis risk can only be effectively addressed when mortgage assets and non-mortgage assets are based on HIBOR to match the funding base or when related risk management instruments become more prevalent or economical. Over the past few years, the Corporation has consciously adopted the strategy of acquiring more HIBOR-based assets and as at the end of 2006, about 70% of the Corporation's mortgage assets and non-mortgage assets are HIBOR-based loans. As a result, the Prime-HIBOR basis risk for the Corporation has been substantially reduced. In addition, the issuance of Prime-based MBS and the use of hedging derivatives have also been deployed to mitigate the basis risk of the Prime-based portion of the Corporation's mortgage portfolio.

Maturity Mismatch Risk

While the contractual maturity of a mortgage loan can go up to 30 years, the average life of a portfolio of mortgage loans is in reality much shorter. The average life will depend on the speed of scheduled mortgage repayments and unscheduled prepayments. Higher prepayment rates will shorten the average life of a portfolio of mortgage loans. In Hong Kong, prepayment occurs for two main reasons: (i) housing turnover - borrowers repaying their mortgages upon the sale of the underlying property; and (ii) refinancing - borrowers refinancing their mortgage loans to obtain lower mortgage rates.

The maturity mismatch risk can be more specifically analysed as reinvestment risk and refinancing risk. Reinvestment risk refers to the risk of a lower return from the reinvestment of proceeds received by the Corporation (from prepayment and repayment of mortgage loans). Refinancing risk, on the other hand, is the risk of refinancing liabilities at a higher level of interest rate. The Corporation is exposed to refinancing risk when it uses short-term liabilities to finance long-term mortgage assets.

Reinvestment risk is managed through the ongoing purchases of new mortgage loans to replenish the repaid mortgages in the retained portfolio and the investment of surplus cash in debt securities or cash deposits to fine-tune the average life of the overall pool of assets.

Refinancing risk is managed through the issuance of callable bonds and transferable loan certificates. The call option included in callable bonds and transferable loan certificates will allow the Corporation to adjust the average life of its liabilities to match more closely that of the overall pool of assets. In this regard, the Corporation has the flexibility of issuing debt securities on a broad spectrum of maturities ranging from 1 year to 15 years. This will again serve to adjust the average life of the overall liability portfolio in a dynamic fashion. In addition, refinancing risk can be mitigated by adjusting the maturities of assets in the investment portfolio and off-loading mortgage assets through securitisation of mortgage loans as MBS.

c) Liquidity Risk

Liquidity risk represents the risk of the Corporation not being able to repay its obligations (such as redemption of debt issuance) or to fund committed purchases of mortgage loans. Liquidity risk is managed through 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 Corporation has successfully established well-diversified funding sources to support the growth of its business and the maintenance of a well-balanced portfolio of liabilities. The diversification allows us to pursue a strategy of funding business activities at the lowest possible cost whilst at the same time offering safeguards against the inability to raise funds in unfavourable market conditions. The funding sources currently comprise:

(i) Shareholders' Capital: authorized capital of HK$3 billion, of which HK$2 billion is fully paid up. Accumulated shareholders' funds amounted to HK$5.1 billion as at 31 December 2006;

(ii) HK$40 Billion Debt Issuance Programme: there are 6 Primary Dealers and 15 Selling Group Members which will underwrite and distribute debts to institutional investors under the DIP. The Transferable Loan Certificate Sub-Programme under the DIP provides a further diversification of funding sources and broadening of investor base;

(iii) HK$20 Billion Retail Bond Issuance Programme: this debt issuance programme has 19 Placing Banks which will assist in offering retail bonds to investors;

(iv) US$3 Billion Bauhinia Mortgage-Backed Securitisation Programme: with a total of 8 Dealers, this multi-currency mortgage-backed securitisation programme permits the HKMC to originate MBS in the local and international markets;

(v) Cash and Debt Investment Portfolio: the Portfolio comprises cash and bank deposits, commercial papers, high-quality certificates of deposit, notes and MBS that can be readily converted into cash;

(vi) HK$10 Billion Revolving Credit Facility: this is a commitment from the Exchange Fund to provide the Corporation with HK$10 billion in revolving credit; and

(vii) Money Market Lines: the Corporation has procured money market lines from a large number of local and international banks for short-term financing.

Asset and Liability Committee

ALCO is established with the CEO as Chairman, the Senior Vice President (Finance), the Senior Vice President (Operations), and senior staff of Treasury, Financial Control and Credit Approval and Risk Management Departments as members. ALCO performs the important task of managing the Corporation's asset-liability portfolio based on prudent risk management principles. Strategies on interest rate risk management, financing, hedging, investments are formulated by the Committee. A weekly meeting is held to review the latest conditions in the financial markets and the asset-liability portfolio mix.

ALCO oversees the implementation of risk management and investment guidelines approved by the Board of Directors. The Treasury Department is responsible for monitoring financial market movements and executing transactions in the cash, derivatives and debt markets in accordance with the strategies laid down by ALCO. The Financial Control Department assumes a middle office role and monitors the compliance of counterparty and transactions risk limits.

d) Currency Risk

Currency risk represents the impact of fluctuations in foreign exchange rates on the company's financial position and cash flows denominated in foreign currency. The Corporation manages its currency risk in strict accordance with the investment guidelines approved by the Board of Directors and under the supervision of ALCO which sets daily monitoring limits on currency exposure. So far, the Corporation has limited its foreign currency exposure to US dollar only.

e) Operational Risk

Operational risk represents the potential loss as a result of the occurrence of certain internal or external operational activities and interruptions due to technology failures or disasters. The Corporation seeks to minimise the possibility of such occurrence by maintaining a comprehensive system of internal controls and procedures. To ensure adequate compliance, the Corporation's key operating systems and processes are subject to regular audit and review by both internal and external auditors.

To reduce potential human errors, the HKMC applies extensive technology solutions with robust business logics and controls to its business operations activities and processes. The Corporation has established a comprehensive disaster recovery plan and business continuity plan, including the establishment of an offsite back-up and disaster recovery centre, to ensure that its information technology ("IT") systems can continue operating even in the event of a core system's failure or other unexpected major disruptions. To cater for a contingency situation that restricts staff access to the office, arrangements have also been made for some staff members to work from home to help maintain the functioning of the Corporation. These well-tested operational risk mitigation measures are in place to strengthen its operational infrastructure with greater resilience and operational robustness and efficiency.

Operating infrastructure will be in place to support launch of new products in different business areas, such as asset acquisition, mortgage insurance, treasury operations, bond issuance and securitisation. The Corporation will go through rigorous risk review processes to identify relevant operational risks for implementation of risk mitigation solutions.

The Corporation completed a number of initiatives in 2006 as a further strengthening of the operational framework as follows:

a) implementation of straight-through processing and integration between treasury and payment system;

b) completion of the second phase of integration with the global SWIFTNet services;

c) completion of pilot development of a new operational model to streamline both the servicing requirements for our Approved Servicers and internal operating procedures;

d) enhancement of the asset acquisition and management system for purchase of new assets; and

e) revamp an underwriting system for pre-purchase assessment of loan assets to be purchased by the HKMC.

Process Management and Information Technology

A well-tested operational framework supported by appropriate systems automation and control are the key to ensuring efficiency and accuracy in the Corporation's daily operations. Since inception, the Corporation has continuously been developing and upgrading various application systems.

Since the launch of the new Mortgage Insurance Programme System ("MIPS") in 2005 based on the IT Strategic Plan, the Corporation has been working towards a paperless environment in its MIP operations. Imaging technology has been employed to handle the vast amount of paper documents such as loan application forms and supporting documents and to shorten the processing time up to 1-day turnaround time for MIP application in general.

To allow MIP loan applicants to enquire their application status, the Corporation has equipped its website with an online enquiry function. It provides a convenient and express channel for MIP loan applicants to enquire the most updated application status. This online service is available 24-hours a day including Sundays and Public Holidays.

The Corporation has completed the full integration between SWIFTNet and our treasury system in September 2006 to provide a straight-through processing for treasury transactions. Operational efficiency and reliability have been improved by replacing the paper-based operations with the fully automated electronic processing. Settlement details are integrated directly to external counterparts through a secured network allowing full protection of data integrity and better management of operational risk.

An underwriting system was launched in October 2006 to support pre-purchase assessment of loan assets to be purchased by the Corporation. The development has made use the object-oriented technology to improve the productivity in terms of programming and system quality control. The technology enables programmer to reuse the well-tested modules from existing systems to speed up the new development with similar functionalities. Moreover, we have also adopted the image recognition technology currently employed under MIPS for document processing. This approach allows the Corporation to better utilize IT resources.

Business Continuity Plan

To cater for the possible outbreak of Avian Influenza Pandemic, the Corporation has updated the business continuity plan as well as the work-from-home capability of staff members in 2006. The disaster recovery site has also upgraded with a new wireless network to expand the capacity of workstations. To test the Corporation's ability to deal with unforeseen disruption in business continuity, drills of the business continuity plan and the disaster recovery plan were conducted respectively in March and December 2006.

Human Resources

Staffing

As the HKMC promotes the development of the secondary mortgage market, it attracts and also trains up professionals with expertise in its key business areas of mortgage purchase, mortgage insurance and debt issuance. Through system automation and process re-engineering, the Corporation maintains a lean and efficient workforce, notwithstanding the increase in the scope of purchase and the complexity of the products offered by the Corporation. The permanent establishment was 117 in 2006.

The Corporation continued to experience a high staff turnover rate of 19.9% in 2006, covering staff of all ranks in the Corporation.

Staff attending training course

Training and Development

The HKMC devotes considerable training resources to equip its staff with professional knowledge and skills. During the year, the HKMC arranged both in-house and external courses to improve the managerial and technical skills of the staff. Courses were offered to cover mortgage-related issues, credit management, information technology, and management skills. In addition, intra and inter-departmental team building workshops, Business English Writing workshops and practical Putonghua lessons were also arranged during the year.

New staff attended an induction programme which gave them an overview of the Corporation's operations as well as their own area of work.

Employee Relations and Staff Activities

As a caring employer, the HKMC continued to promote the health and emotional well-being of its staff. An Employee Support Programme was in place to provide counseling, consultation services and health seminars to the employees.

To further enhance effective communication in the Corporation, the HKMC introduced a new Staff Homepage to facilitate sharing of useful information among departments. The HKMC also offered Staff Suggestion Scheme to encourage staff to suggest ways to improve the work flow or the work place.

Staff Suggestion Scheme

The HKMC Staff Club organised a number of well-received staff activities to cultivate better employee relationships and communication. Staff activities included hiking, table manner class, bowling fun day and interest classes in Erhu and Yoga. The HKMC also participated in Table Tennis Friendly Game and Soccer Game with other public organisations.

The HKMC staff supported various charitable and fund-raising activities during the year. The HKMC Music Group performed and raised funds for the Salvation Army Shop for the Elderly. Donation campaign was also organised for the Community Chest through the Dress Special Day.

Office Administration

The HKMC continued to support and implement green office measures to make the office more environmentally friendly. Staff awareness was raised through increased use of electronic communications and recycling of waste paper. New measure in setting office temperature was adopted in 2006 in the interest of energy efficiency. The HKMC also encouraged its staff to make suggestions for a greener office.

During the year, the HKMC stepped up efforts to review and strengthen its business continuity plan to handle unexpected or sudden disruptions to daily operations. Periodic drills were organised for staff to be conversant with the activation of the back-up facilities, the contingency plans and communication arrangements in case of emergency.

2007 Outlook

The HKMC will continue to maintain a viable operation to meet its core objectives to contribute to banking stability through provision of liquidity when needed, promote homeownership and facilitate the development of the local debt and securitisation markets. In accordance with the new business strategy approved by the Board, the Corporation will be seeking to expand its businesses in Hong Kong through diversification beyond residential mortgage loans and in the region through exploration of business opportunities involving purchase of mortgage loans and provision of mortgage insurance or guarantee.

The diversification of asset coverage in Hong Kong will better enable the Corporation to provide liquidity to banks in Hong Kong against a wider range of assets. The expansion overseas will enable the Corporation to use its experience and expertise to contribute to the development of the mortgage financing market in the region and help to enhance Hong Kong's standing as an international financial centre.

The HKMC will seek to improve the operation of its Mortgage Insurance Programme and its product offerings to better meet the needs of the market and the homebuyers. The Corporation has been working on access to the consumer credit data base to enhance the underwriting process so that more accurate credit assessment can be made. This can foster a healthy, long-term development of the mortgage insurance market that is in the interest of promoting home ownership.

As regards the development of the local debt market, the Corporation will continue to maintain its active profile in the market and issue corporate bonds and securitise mortgage loans into MBS to fund its asset acquisition and debt redemption as well as to meet the needs of investors.

HKMC Charity Night

Dress Special Day

Table Tennis Friendly Game

Company Hiking