Financial Review

The Corporation achieved a record profit at HK$683 million, an increase of 13.5% over 2005. With the progressive expansion and diversification of its businesses, the Corporation is set to produce sustainable financial results to better fulfil its core objectives as well as promoting Hong Kong's status as an international financial centre.

Income Statement

Financial Performance

With the increasing synergy between the economies of Mainland China and Hong Kong, the local economy has staged a strong recovery in 2006 with GDP up by 6.8% for 2006. Along with the rise in GDP, the consumer price index stayed at relatively low level of 2% for 2006. The unemployment rate further eased from an average of 5.6% in 2005 to an average of 4.8% in 2006 due to the extensive improvements in the labour market.

Development of the property market was steady for 2006 and property prices were largely stable as compared to the rallies in past two years. With fund inflow for the initial public offering of Chinese-based companies and ample liquidity within the local banking system, competition among banks for mortgage loans remained keen while some banks offered HIBOR-based mortgage even more

FIGURE 1

Summary of financial performance

	2006 HK$ million	2005 HK$ million (Restated)
Operating profit before impairment	**753.8**	671.3
Profit before tax	**762.3**	690.5
Profit after tax	**682.7**	601.3
Return on shareholders' equity	**13.9%**	13.6%
Return on assets	**1.6%**	1.3%
Cost-to-income ratio	**13.5%**	14.7%
Capital-to-assets ratio	**11.2%**	12.0%

aggressively to attract homebuyers to the market. Coupled with the US Federal Reserve taking a pause from its two-year tightening cycle and the liquidity in local banking system, banks reduced Prime rate by a quarter in November 2006 and the property market began to show modest signs of turnaround.

Given the solid economic growth, the stable property market, and the favourable interest rate environment, the HKMC achieved a record profit after tax of HK$682.7 million in 2006, an increase of 13.5% compared with 2005. (Figures 1 and 2)

Operating profit before impairment increased by HK$82.5 million, or 12.3% to HK$753.8 million. The increase in net interest income by 8.4% combined with a 22.8% increase in other income outweigh the modest increase of 1.6% in operating expenses.

The return on shareholders' equity remained strong at 13.9% (2005: 13.6%), while the return on assets improved to 1.6% (2005: 1.3%). Operating expenses were well contained by effective cost control with modest increase compared to 2005. The substantial increase in income base reduced the cost-to-income ratio to 13.5% (2005: 14.7%). The capital-to-assets ratio maintained at 11.2% (2005: 12.0%), well above the guideline of a minimum 5% stipulated by the Financial Secretary.

The net interest income for the year increased by 8.4% from HK$661.6 million to HK$717.2 million (Figure 3), mainly benefiting from the widening of Prime-HIBOR spread in 2006 on our prime-based loan portfolio. The Prime-HIBOR spread widened from a monthly average of 3.4% in 2005 to 4.0% in 2006. Taking into account the shareholders' equity, the net interest margin remained healthy, uplifting from 1.5% to 1.7%.

FIGURE 2

Profit after tax

FIGURE 3

Net interest income

	2006 HK$'000	2005 HK$'000 (Restated)
Interest income	**2,294,607**	1,773,009
Interest expense	**(1,577,391)**	(1,111,458)
Net interest income	**717,216**	661,551
Average interest-earning assets	**42,201,212**	44,734,633
Net interest margin	**1.7%**	1.5%
Net interest spread on interest-bearing liabilities[1]	**1.2%**	1.2%

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

Net Other Income

Net other income reported a significant growth of 22.8% to HK$154.4 million in 2006 (2005: HK$125.7 million). The growth in net other income was underpinned by the increase in exchange gain and the new stream of income from dividend received on investment portfolio, partly offset by the decrease in early prepayment fees. (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. Driven by the fall in approved new residential mortgage loans in the market from HK$142.8 billion in 2005 to HK$115.1 billion in 2006, our new business underwritten under MIP declined from HK$18.1 billion to HK$9.2 billion and the market penetration rate decreased from 20% to 13.3%. The risk-in-force borne by us grew by 10.4% to HK$2.9 billion in 2006. As a result, the net premium earned for the year increased slightly by 1.2% from HK$101.2 million in 2005 to HK$102.4 million in 2006.

In light of the favourable exchange rate at the end of 2006 when compared to 2005, exchange gain rose by HK$18 million to HK$23.2 million (2005: HK$5.2 million), primarily due to the revaluation on US dollar exposures.

Early prepayment fees were HK$19.6 million, or 30% lower than 2005 (2005: HK$28 million), affected by the sluggish performance of property market, notwithstanding the increase in refinancing activities triggered by fierce competition on mortgage market.

Dividend income of HK$16 million from listed investment securities equivalent to a dividend yield of about 5% was received in 2006. As a result of the expansion of investment activities with an aim to enhance the return on investment, the HKMC has diversified its investment portfolio to non-interest earning securities, which are either bond fund or real estate investment trust.

Operating Expenses

The HKMC continued to maintain stringent cost controls to contain expenses while seeking to expand the scope of business. Operating expenses slightly increased by 1.6% to HK$117.8 million as compared to 2005. Staff costs decreased by 1.5% to HK$74.7 million, after taking account of staff turnover, and accounted for 63.4% of total operating expenses (2005: HK$75.8 million and 65.4%).

FIGURE 4

Major source of other income

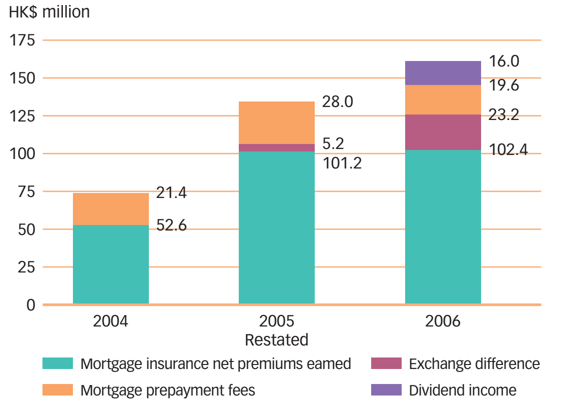

FIGURE 5

Operating expenses

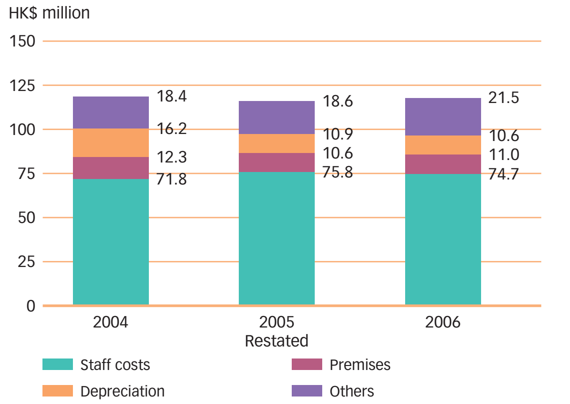

FIGURE 6

(Write-back) of loan impairment allowances/ allowance for loan impairment

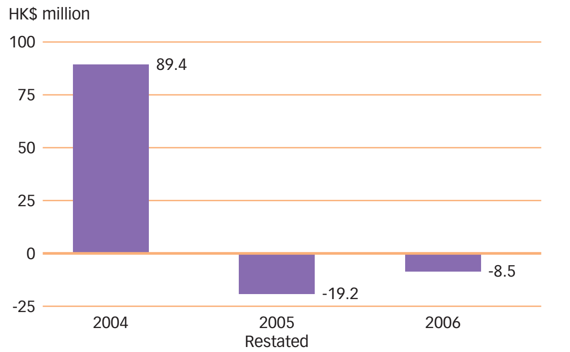

FIGURE 7

Ratios

	2006	2005 (Restated)
Delinquency ratio for loan portfolio overdue for more than 90 days	**0.19%**	0.22%
Total allowance for loan impairment as a percentage of the gross loan portfolio	**0.09%**	0.17%

The decline in staff costs were, however, offset by the consultancy fee paid to a management consultancy firm for conducting strategic review of the HKMC's strategy and long-term prospects. Premises rental and the related costs increased slightly by HK$0.4 million to HK$11 million. Depreciation charges on assets fell marginally by 2.8% to HK$10.6 million (2005: HK$10.9 million). (Figure 5)

Allowance for Loan Impairment

Asset quality remained strong, with the delinquency ratio falling from 0.22% to 0.19%. Collective assessment for loan impairment of HK$8.5 million was released to the income statement upon further improvement in the repayment ability of borrowers as compared to the release of HK$19.2 million in 2005. (Figure 6)

Total allowance for loan impairment accounted for 0.09% of the outstanding principal balance (HK$32.4 billion) of the loan portfolio as at the end of 2006. (Figure 7)

Balance Sheet

Total assets rose by HK$1.3 billion to HK$44.8 billion (2005: HK$43.5 billion), mainly due to the increase in investment securities by HK$2.8 billion to HK$9.3 billion, partly offset by the reduction in cash and short-term funds by HK$0.6 billion to HK$1.9 billion, and the contraction of loan portfolio by HK$1.1 billion. (Figure 8)

Loan Portfolio

The HKMC purchased an aggregate amount of HK$6.4 billion of loans in 2006 (2005: HK$2.9 billion), including HK$1.4 billion of taxi loans and HK$5 billion of mortgage assets. The average prepayment rate of the loan portfolio (including those securitised mortgages) dropped from 15.4% in 2005 to 12.7% for 2006. Given the low prepayment rate of the loan portfolio partially offset by the increase in loan purchases in 2006, the loan portfolio, including the HK$2 billion of mortgages securitised in 2006, recorded a net decrease by HK$1.1 billion to HK$32.4 billion. (Figure 9)

Investment Securities

The HKMC's investment portfolio is mainly made up of bank deposits, certificates of deposit, bonds, yield-based bond funds and real estate investment trust. The portfolio serves as a liquidity buffer to support HKMC's business operations and income enhancement. 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 guideline. As at 31 December 2006, the total investment portfolio grew from HK$6.5 billion in 2005 to HK$9.3 billion including HK$4.6 billion of available-for-sale investments and HK$4.7 billion of held-to-maturity investments with funds redeployed from lower yielding cash and short-term funds.

FIGURE 8

Asset deployment

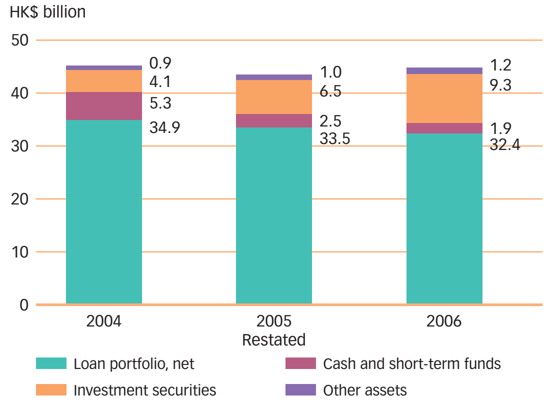

FIGURE 9

Loan portfolio, net

	2006 HK$'000	2005 HK$'000 (Restated)
Mortgage portfolio		
Retained portfolio	**27,337,240**	29,528,436
Securitised portfolio	**3,796,048**	4,076,269
Non-mortgage portfolio	**1,291,032**	–
Allowance for loan impairment	**(30,228)**	(55,847)
Loan portfolio, net	**32,394,092**	33,548,858

Debt Securities Issued

The HKMC issued a total of HK$13.3 billion of Hong Kong dollar and US dollar debts in 2006, comprising HK$12 billion debts under the DIP and HK$1.3 billion retail bonds under the RBIP. As at 31 December 2006, the total outstanding balance of the debts issued rose slightly by 3.2% or HK$0.9 billion to HK$28.9 billion as compared with 2005. The rise reflected the net increase after redemption of HK$12.7 billion debts matured in 2006 and the resulting change in fair value of debt securities issued. The average remaining term of the loan portfolio was 9 years on a contractual basis while 47.7% of the HKMC's outstanding debts would mature in the range of 1 to 5 years.

Mortgage-backed Securities Issued

The HKMC issued HK$2 billion of mortgage-backed securities under the Bauhinia Mortgage-Backed Securitisation Programme in 2006. After accounting for the redemption of HK$1.8 billion in 2006, the total outstanding balance of the mortgage-backed securities issued increased slightly by 3.8% or HK$0.2 billion to HK$5.4 billion compared with 2005.

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, non-residential mortgage loans, the MIP and non-mortgage loans. (Figure 10)

The capital base, defined as shareholders' equity plus the allowance for loan impairment under collective assessment, grew by 15.6% from HK$4.5 billion to HK$5.2 billion in 2006. At the end of 2006, the aggregate amount of the HKMC's on-balance sheet assets and off-balance sheet exposure was HK$43.7 billion, which mainly consisted of HK$24.3 billion of risk-weighted mortgage loans, HK$2.1 billion of risk-weighted hire purchase assets, HK$9.3 billion of investment securities, HK$1.9 billion of cash and bank balances, HK$2.9 billion of risk-weighted mortgage insurance exposure and HK$1 billion of 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 11.2% (2005: 12.0%).

Dividend

At the Annual General Meeting held on 26 April 2007, Shareholders approved a final dividend of HK$0.125 (2005: HK$0.125) per share, totalling HK$250 million, representing 36.6% of the profit after tax.

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
Non-residential mortgage loans	8% of the non-residential mortgage loan portfolio
Non-mortgage loans	8% of the non-mortgage loan portfolio