Financial Review

year of harvest

The Corporation achieved a record profit after tax of HK$664 million, with the return on shareholders' equity reaching a high of 17.1%. For the first time, the Corporation declared a dividend of HK$250 million.

Profit and Loss Account

Operating results

The Hong Kong economy grew robustly in 2004 with GDP growth of 8.1%, in contrast to 2003 when the economy was dampened by the outbreak of SARS in the first half of the year. The economic recovery was given a big boost by the expansion of China's Individual Visit Scheme and the signing of the Closer Economic Partnership Agreement. With the pick up in the local consumption and investment activities, the unemployment rate dropped from 7.3% in the last quarter of 2003 to 6.5% at 2004 year-end, and the property market sharply recovered by an average increase in value of 27%. Under this favourable business environment, the Corporation achieved a record profit after tax of HK$664 million in 2004, an impressive increase of 75.2% over 2003. As a result, the shareholders' equity increased to HK$4.2 billion, which represents a doubling of the paid-up capital of HK$2 billion over the past seven years. (Figures 1 and 2)

Good financial results were attributable to the combined effect of the impressive growth in the mortgage purchase and mortgage insurance businesses in recent years, the strong recovery of the property market and a favourable interest rate environment. Profit before provisions was HK$852.8 million, up HK$291.7 million or 52%, as compared to 2003.

The return on shareholders' equity rose sharply to 17.1% (2003: 11.5%) and the return on assets surged to 1.3% (2003: 1.0%). As a result of effective cost control and impressive increase in fee incomes, the cost-to-income ratio fell from 17.4% in 2003 to 12.2% in 2004. The capital-to-assets ratio (CAR) strengthened to 9.4% from 7.7% in 2003, well above the minimum 5% guideline stipulated by the Financial Secretary.

The net interest income for the year grew by 30.6% from HK$621.4 million to HK$811.7 million, (Figure 3) reflecting mainly the contribution from a favourable net interest spread generated from the retained mortgage portfolio and the

FIGURE 1

	2004 HK$ million	2003 HK$ million
Operating profit before provisions	**852.8**	561.1
Profit before taxation	**763.4**	423.0
Profit after taxation	**664.0**	379.1
Return on shareholders' equity	**17.1%**	11.5%
Return on assets	**1.3%**	1.0%
Cost-to-income ratio	**12.2%**	17.4%
Capital-to-assets ratio	**9.4%**	7.7%

FIGURE 2

Profit after taxation

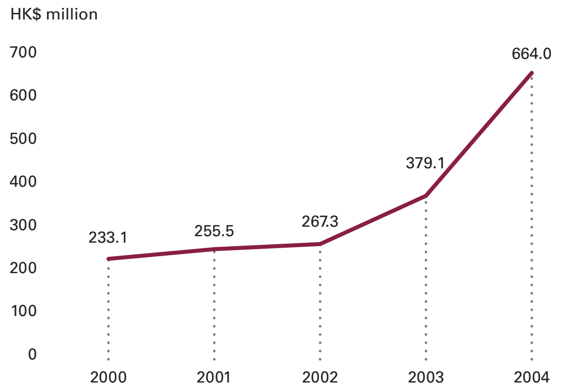

FIGURE 3

Net interest income

	2004 HK$'000	2003 HK$'000
Interest income	**1,021,874**	1,006,846
Interest expense	**(210,165)**	(385,427)
Net interest income	**811,709**	621,419
Average interest-earning assets	**49,408,963**	37,014,673
Net interest margin	**1.6%**	1.7%
Net interest spread on interest-bearing liabilities[1]	**1.6%**	1.6%

1 Net interest spread on interest-bearing liabilities = Return on interest-earning assets less funding costs on interest-bearing liabilities significant increase in the average interest-earning assets. The exceptionally wide Prime-HIBOR spread, at a monthly average of 4.7% in the year, widened the net interest spread of the Prime-based mortgage portfolio. Notwithstanding a significant reduction in mortgage rates charged by the banks, the net interest margin remained healthy, falling slightly from 1.7% to 1.6%.

Net other income

Net other income achieved an impressive growth of 166.3% to HK$159.8 million in 2004 (2003: HK$60 million). This was mainly attributable to the growth in fee income from MBS, mortgage insurance premiums earned and prepayment fees received. (Figure 4)

Fee income from the guaranteed MBS business rose by 176.5% from HK$31 million to HK$85.7 million in 2004 as a result of the securitisation of HK$2.4 billion of mortgage loans in 2004 and the exceptionally wide Prime-HIBOR spread.

Net mortgage insurance premiums written under the MIP increased sharply by 85.8% to HK$124.7 million, reaping the rewards from the increase of the maximum LTV ratio from 90% to 95% in July 2004 which helped the market penetration rate rise from 13.5% to 16% in 2004. As a result, the net premium earned for the year increased by 37.3% from HK$38.3 million to HK$52.6 million. Triggered by the sharp recovery of the property market, prepayment fees grew significantly by 756% to HK$21.4 million (2003: HK$2.5 million).

Operating expenses

The Corporation continued to maintain the overall costs at a reasonable level and implemented stringent cost controls to contain expenses during the expansion of the business. While the profit increased, the operating expenses fell slightly by 1.3% to HK$118.7 million over 2003. Staff costs increased by 5.4% to HK$71.8 million, which, as a result of the business expansion, accounted for 60.5% of total operating expenses (2003: HK$68.1 million and 56.6%). The increase in staff costs was offset by the net savings in premises and other related expenses due to the relocation to the new office in Two International Finance Centre in July 2004. Premises cost and its related costs dropped by HK$5.2 million to HK$12.3 million, mainly due to the early surrender of the old office premises. Depreciation charges on new assets and renovation for new office increased by 8.7% to HK$16.2 million (2003: HK$14.9 million). (Figure 5)

Provisions for bad and doubtful loans

The reduction of general provision by HK$23.6 million led to a release of HK$5.4 million as a result of an improvement in the credit risk exposure of the retained mortgage portfolio. (Figure 6)

With the improvement in personal bankruptcy situation and unemployment rate, the charge on specific provisions fell by 27.7% to HK$94.9 million (2003: HK$131.2 million), notwithstanding the increase in the size of the retained mortgage portfolio (before provisions) by HK$0.4 billion over 2003. (Figure 9)

Total loan provisions accounted for 0.33% of the outstanding principal balance (HK$35.1 billion) of the retained mortgage portfolio at year-end of 2004. (Figure 7)

Balance Sheet

In 2004, total assets grew by 9.8% from HK$40.9 billion to HK$44.9 billion. The asset growth was mainly due to an increase in the cash and short-term funds by HK$3.1 billion to HK$5.3 billion, an increase in investment in debt securities by HK$0.6 billion to HK$4.1 billion and an increase of HK$0.3 billion in the net mortgage portfolio to HK$34.9 billion. (Figure 8)

Mortgage Portfolio

During the year, the Corporation purchased an aggregate amount of HK$11.4 billion of mortgage loans. As a result of the continual drop in mortgage rates to an average of Prime rate less 2.8% which led to an increase in refinancing activities on mortgage loans, the average

FIGURE 4

Major source of other income

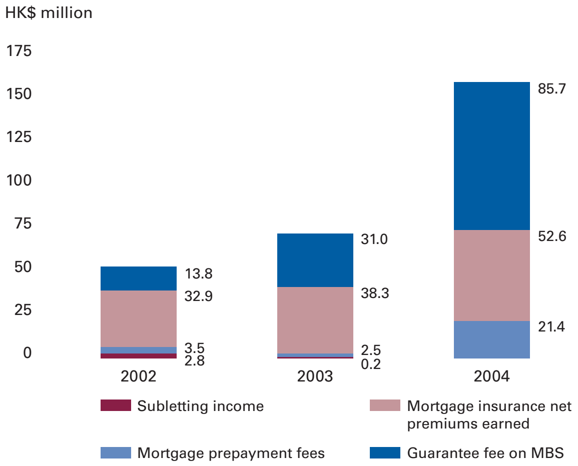

FIGURE 5

Operating expenses

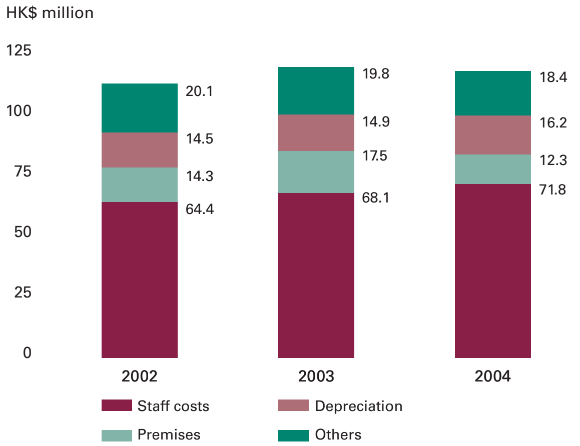

FIGURE 6

Charge for bad and doubtful loans

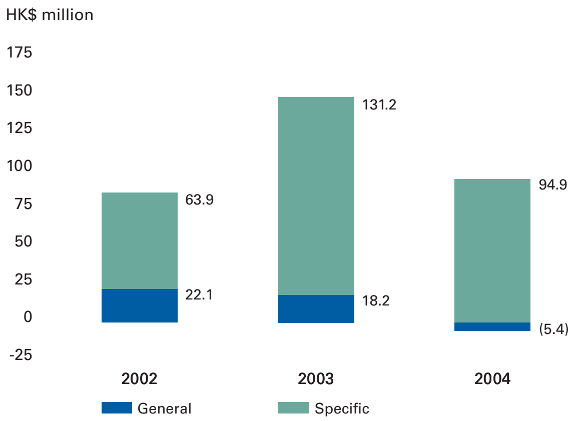

FIGURE 7

Ratios[1]

	2004	2003
Delinquency ratio for mortgage portfolio overdue for more than 90 days	**0.36%**	0.77%
Total loan provisions as a percentage of the gross mortgage portfolio	**0.33%**	0.24%

1 Loans overdue for 180 days or more, with collateral repossessed or mortgagors who declared bankruptcy, were written down to the forced sale value of the properties and reclassified from "Mortgage portfolio, net" to "Other receivables, net". Without accounting for this reclassification, loan provisioning was 0.49% (2003: 0.54%) of the outstanding principal balance of the total mortgage loans.

FIGURE 8

Asset Deployment

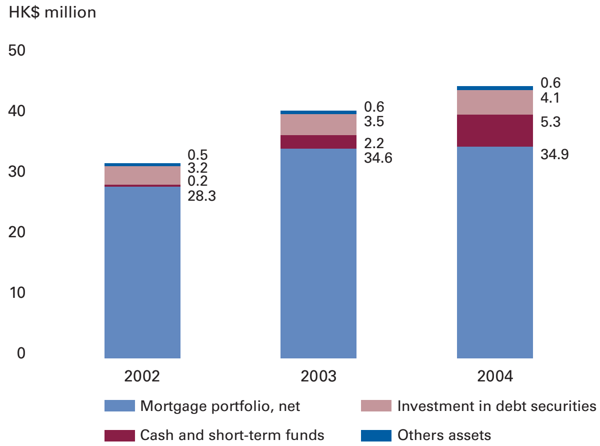

FIGURE 9

Mortgage Portfolio

	2004 HK$'000	2003 HK$'000
Gross mortgage portfolio	**35,052,688**	34,664,075
Provisions for bad and doubtful loans		
Specific	**(56,150)**	(13,863)
General	**(57,958)**	(68,465)
Mortgage portfolio, net	**34,938,580**	34,581,747

prepayment rate of the retained mortgage portfolio (including those securitised mortgages carrying HKMC's guarantee) surged from 8.6% in 2003 to 12.5% for 2004. Excluding the HK$2.4 billion of MBS issued in the year, the net retained mortgage portfolio recorded a slight net increase of HK$0.3 billion to HK$34.9 billion.

Investment in debt securities

The debt investment portfolio comprises bank deposits, certificate of deposits and bonds and serves as a source of liquidity to support the business operations. The Corporation invests surplus funds according to the approved investment guidelines. All invested debt securities are booked in the held-to-maturity account, of which over 70% will mature within five years. As at 31 December 2004, the investment portfolio was HK$4.1 billion, compared to HK$3.5 billion in 2003.

Debt securities

The Corporation issued a total of HK$11.4 billion of Hong Kong dollar debts in 2004, of which HK$8.5 billion was issued under the DIP and HK$2.9 billion retail bonds under the RBIP and on a standalone basis. As at 31 December 2004, the total outstanding balance of the debts issued decreased slightly by 3.1% or HK$1.1 billion as compared with 2003. The drop was caused by the redemption of HK$12.5 billion debts which matured in 2004. The average life of the retained mortgage portfolio was 11 years while 60.1% of the outstanding debts will mature in the range of 1 to 5 years.

Capital Management

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

The capital base, defined as shareholders' equity plus the general provision for bad and doubtful loans, grew by 11.1% from HK$3.6 billion to HK$4 billion in 2004. At the end of the year, the aggregate amount of the on-balance sheet assets and off-balance sheet exposure was HK$42.3 billion, which mainly consists of HK$27.0 billion of risk-weighted mortgage loans, HK$4.1 billion debt securities investments, HK$1.8 billion risk-weighted mortgage insurance exposure and HK$2.4 billion risk-weighted guarantee exposure under the MBS programmes. The CAR was maintained well above the minimum CAR of 5% stipulated by the Financial Secretary at a healthy

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 under the HSLS and SCHLS	2% of HSLS and SCHLS loans (based on outstanding principal balance or committed amount plus accrued interest)
MBS	2% of MBS portfolio (based on outstanding principal balance plus accrued interest)
MIP	0% of risk-in-force value of exposure covered by the reinsurance arrangements with the Approved Reinsurers 5% of risk-in-force value of exposure not covered by the reinsurance arrangements

level of 9.4% (2003: 7.7%), or equivalent to 20.8% (2003: 16.6%) when calculated in accordance with the capital adequacy framework under the Banking Ordinance.

Dividend

Since the establishment of the Corporation in 1997, the Corporation has steadily built up the scale of its business and a solid base of retained earnings. In order to increase the corporate value and partly realise shareholders' return on investment, the Corporation considered that it was an appropriate time to propose the first distribution of a dividend to the shareholders. Accordingly, the Corporation declared and paid out in April 2005 a final dividend of HK$0.125 per share, totalling HK$250 million, representing around 37.7% of the profit for 2004.

Foreign Exchange Exposure

The Corporation's foreign exchange exposure is created for asset and liability management purposes and consists of foreign currency deposits and debt securities investments. During 2004, the Corporation faced increasing challenges in managing cash arising from the higher mortgage prepayment rate, lower mortgage purchases and larger pre-funding amounts. The Corporation has placed the surplus funds in debt investments and bank deposits in Hong Kong dollars and US dollars according to the approved investment guidelines. So far the only foreign currency exposure has been limited to US dollars.

As at 31 December 2004, the net US dollar position is shown in Figure 11.

Off-balance Sheet Exposures

The Corporation's major off-balance exposures include guarantees given in relation to MBS, risk exposure on MIP business and credit risk exposure of interest rate swap contracts. (Figure 12)

In return for guarantee fees, the Corporation provides guarantees on the timely payment of principal and interest to the noteholders of the MBS issued by Bauhinia MBS Limited and HKMC Funding Corporation (1) Limited. During 2004, the contingent amount of the guarantees increased by 11.6% to HK$5.9 billion, reflecting the two new MBS issues by Bauhinia MBS Limited in June and November respectively.

The Corporation operates the MIP business on a risk-sharing basis with four Approved Reinsurers,

FIGURE 11

Total foreign currency positions

	2004 HK$ million equivalent	2003 HK$ million equivalent
Spot assets and net long position	**7,831**	3,278

FIGURE 12

Outstanding positions

	2004 HK$ million	2003 HK$ million
Guarantee under MBS	**5,869**	5,257
Risk-in-force exposure under MIP	**1,774**	1,090
Interest rate swap contracts		
– Notional contract amount	**73,869**	77,749
– Replacement cost	**1,115**	1,345

retaining up to 50% of the risk exposure under the mortgage insurance covers. As a result of the recovery of the property market and the increase of the maximum LTV ratio permitted under the MIP to 95%, the MIP achieved a strong growth of 89.3% in new business underwritten and the risk-in-force borne by the Corporation grew sharply by 62.8% to HK$1.8 billion in 2004.

The Corporation makes use of interest rate swaps for asset and liability management purposes, using them to convert fixed-rate bonds to HIBOR-based liabilities to fund floating-rate mortgage assets. As at 31 December 2004, the notional amount of interest rate swap contracts was HK$73,869 million, slightly down from HK$77,749 million for 2003. The notional amount of the interest rate swap contacts does not represent the amount of credit risk to which the Corporation is exposed. Instead, the credit risk exposure the Corporation faces is measured by the replacement cost, assuming the corresponding swap counterparts default on the swap contract. In practice, the Corporation only deals with swap counterparts with single-A credit rating or above. The replacement cost was HK$1,115 million as compared with HK$1,345 million in 2003.

Impact of New Accounting Standards on the HKMC

Following the convergence of the Hong Kong accounting standards with the international accounting standards set by the International Accounting Standards Board, the Hong Kong Institute of Certified Public Accountants issued a number of new and revised Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards (new HKFRSs) which took effect on 1 January 2005.

The adoption of the new HKFRSs will trigger significant changes in the Corporation's accounting policies. The major changes are summarised as follows:

- de-recognition of the securitised assets using the de-recognition rule for financial instruments. Securitised assets and corresponding liabilities, which were previously permitted to be treated as off-balance sheet items, are required to be treated as on-balance sheet items;
- subject to the passage of the Companies (Amendment) Bill 2004, the assets and liabilities of the two special purpose entities, namely HKMC Funding Corporation (1) Limited and Bauhinia MBS Limited, created solely for securitisation business, which were previously treated as non-consolidated entities, will be required to be consolidated with the Corporation's operating results and financial position;
- the inclusion of certain financial instruments and all derivatives in the balance sheet at fair value;
- change of the provisioning method to loan impairment based on the discounted cash flow of delinquent loans and the impact of macro-economic factors on performing loans;
- adoption of the effective interest rate method for recognition of interests on assets and liabilities;
- hedge accounting for investment products; and
- recognition and measurement of assets and liabilities relating to insurance contracts as well as the disclosure of information on those contracts.

The Corporation does not expect the application of the new HKFRSs to change the net cash flows or the underlying economics of its business. However, the accounting rules for recording fair values for derivatives, debt securities investment and debt issues are likely to cause volatility in the Corporation earnings. The Corporation has already taken steps to address the above issues and has prepared to evaluate their impact on its operating results and financial position. However, the Corporation is not yet in a position to state the impact of the new HKFRSs on its operating results and financial position. Interim report for the first six months ended 30 June 2005 will reflect the impact of the HKFRSs on the financial statements.