Annual Report 2003 年報

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The Hong Kong Mortgage Corporation Limited
香 港 按 揭 證 券 有 限 公 司

Contents

Financial Highlights

	2003 HK$'000	2002 HK$'000	2001 HK$'000
FOR THE YEAR			
Net interest income	**621,419**	430,956	324,430
Profit after taxation	**379,136**	267,347[1]	255,526
Mortgage purchases	**14,961,822**	14,394,748	13,222,492
Mortgage-backed securities issued	**3,568,860**	2,000,000	632,690
Debt issued	**10,885,540**	14,956,450	15,583,550
Mortgage insurance			
– net premiums underwritten	**67,114**	53,984	58,742
AT YEAR END			
Mortgage portfolio, net	**34,581,747**	28,257,727	19,777,884
Total assets	**40,900,302**	32,191,033[2]	23,219,832
Debt securities	**36,630,290**	28,615,000	20,058,550
Mortgage insurance – risk in force [3]	**1,090,191**	779,779	513,031
OTHER STATISTICS			
Net interest margin	**1.7%**	1.5%	1.5%
Capital-to-assets ratio[4]	**7.7%**	9.0%[5]	11.6%
Cost-to-income ratio	**17.4%**	23.1%	28.2%
Return on assets	**1.0%**	0.9%	1.2%
Return on shareholder's equity	**11.5%**	9.0%[6]	9.4%

1 *The profit after tax is restated in accordance with SSAP 12 (Income Tax), previously reported at HK$263,809,000.*

2 *Total assets are reinstated according to SSAP 12 (Income Tax), previously reported at HK$32,186,615,000.*

3 *The risk in force excludes exposure that has been covered by reinsurance arrangement.*

4 *Computing in accordance with the provisions in the Banking Ordinance, the capital-to-assets ratios of the Corporation were 22.1%, 16.6% and 16.6% for 2001, 2002 and 2003 respectively.*

5,6 *The ratios are restated as a result of restatement of profit after tax in accordance with SSAP 12, both were previously reported at 8.9%.*

Chairman's Statement

The Honourable Henry TANG Ying-yen, GBS, JP
Chairman
Financial Secretary

The HKMC's performance in 2003 showed excellent financial results and further progress in its mission to develop the secondary mortgage market in Hong Kong, despite the difficult operating conditions that persisted until the latter part of the year. The Corporation also played a major role in supporting the Government's asset disposal programme.

To achieve a 41.8% rise in profit after tax in a year made particularly difficult by the outbreak of Severe Acute Respiratory Syndrome (SARS), which severely curtailed property transaction activity, was a substantial achievement. Furthermore, this growth was achieved while maintaining an asset quality that is well above the industry average, with the 90-day delinquency ratio for the HKMC's retained mortgage portfolio standing at 0.27% at year-end, against an industry average of 0.86%. The results therefore testify to the soundness of the HKMC's approach to its operations, which aims to combine growth with high levels of prudence in the management of risk.

Profit after tax increased by 41.8% over 2002 to a record HK$379.1 million

High asset quality maintained

Strong growth in mortgage insurance business

Continued innovation in products and services

The excellent results must also be seen in the wider context of the Corporation having furthered its mission to develop the secondary mortgage market in Hong Kong. The HKMC was established in 1997 to act as the pivotal intermediary channelling funds from the capital market to the mortgage and property markets. By successfully fulfilling this role, the Corporation provides additional sources of funding as well as credit enhancement to the market. This strengthens Hong Kong's financial system, enables banks to offer fixed rate mortgages and mortgages beyond the 70% loan-to-value ratio and thus makes home ownership more affordable and accessible to a wider spectrum of the population.

The activities in 2003 demonstrate the steady progress the HKMC continues to make in these areas, benefitting the entire community of stakeholders, from homeowners to the banking industry and the insurance industry.

Excellent Results and Sound Finances

The financial results for the year 2003 set new records. Net interest income was HK$621.4 million, showing an increase over the previous year of 44.2%, largely as a result of an increase in mortgage purchase activity. Profit after tax rose by 41.8% to HK$379.1 million. Return on equity improved from 9.0% to 11.5% and return on assets from 0.9% to 1.0%. This growth was achieved without any diminution of the Corporation's financial strength. The capital-to-assets ratio remained stable at 7.7%.

The robust nature of the HKMC's operations and its prudent risk management enabled it to maintain its credit ratings from both Standard & Poor's (S&P) and Moody's Investor Service, Inc. (Moody's) which are equivalent to those of Hong Kong SAR Government. The good ratings, according to S&P, reflect that "HKMC has a strong capital base, good asset quality, adequate profitability, and adequate financial flexibility." Equally important, Moody's highlighted that "HKMC's ability to assess and manage risks has resulted in acceptable risk levels well within the Corporation's own guidelines and, in some instances, superior than some of its larger international peers."

Mortgage Purchase Benefits Government Asset Disposals

The strong momentum in the HKMC's mortgage purchases continued during 2003, with a record amount of HK$15.0 billion in assets acquired.

This growth in assets was facilitated considerably by the acquisition during the year of HK$10.5 billion of loans under various Government lending schemes, accounting for half of the amount the Government had targeted to raise from asset disposals during the 2003-2004 financial year. The strategy to expand the range of Approved Sellers to include various entities other than Authorized Institutions has enabled the HKMC to maintain a steady flow of mortgage purchase and strengthened its balance sheet under difficult market conditions. It also assisted the Government in its programme to dispose of assets in order to improve its fiscal position.

Chairman's Statement

Strong Mortgage Insurance Growth

Mortgage insurance showed strong growth, especially during the second half of the year as activity in the residential property market showed some signs of recovery, with the value of loans drawdown under the Mortgage Insurance Programme (MIP) rising from HK$6.2 billion in 2002 to HK$7.5 billion in 2003, an increase of 21%.

The rise in use of MIP products reflects the efforts made by the Corporation to widen the programme's scope through introducing a measure of flexibility into the type of mortgages covered and the type of borrowers that might be considered. Responding to requests by banks, the HKMC has extended MIP coverage for three new mortgage product types. Not only did this increase demand, but no delinquency was recorded on these new products, contributing to the excellent overall performance of the MIP portfolio.

The success of these initiatives led the Corporation towards the end of 2003 to announce its intention to explore a further expansion of the MIP criteria to meet the needs of homebuyers by accommodating additional mortgage and borrower types. This testifies to the soundness of the original expansion scheme and to the close relationships the HKMC has enjoyed with participating banks.

Diversified Funding Activities

The HKMC achieved its funding targets for 2003, benefitting from the historically low interest rates prevailing during the year. In total, the Corporation raised HK$10.9 billion in 2003 through a variety of debt instruments, enabling it to remain soundly financed while pursuing its high levels of mortgage purchase activity. That it was able once again to raise substantial funds, making it for the third year the most active issuer of Hong Kong dollar debts, demonstrates the high regard in which its paper is held by a wide range of institutional and retail investors. To support the growth in the mortgage portfolio, the HKMC doubled the programme size of the Debt Issuance Programme (DIP) to HK$40 billion in January 2003.

The year saw HKMC further develop the mortgage backed securities market in Hong Kong through its second issue under the Bauhinia Mortgage-Backed Securitization Programme that raised HK$3 billion in November. This issue, which broke new grounds by its size and innovative structure, was well received by the market. The enthusiastic response of the underwriting banks was greatly encouraging and the presence of a wide range of institutional investors and fund managers was an especially welcome indication of the breadth of the investor base.

The Corporation also continued to support the development of Hong Kong's retail bond market, of which it has been a pioneer, through the launch of its fifth issue totalling HK$1.3 billion. The issue brought additional benefits to retail investors including a wider choice on tenor and return, with the first 7-year retail bonds and more flexible investment amounts. In the prevailing low interest rate environment, with the savings rate driven down to 0.001%, retail bonds are particularly beneficial to depositors by providing yield enhancement. They also benefit banks since they reduce interest burden on excess deposits and create additional fee income from placing and underwriting retail bonds.

The HK$7.4 billion raised through retail bonds since October 2001 accounts for 27% of the Corporation's debt securities issued, reflecting its commitment to developing this important source of financing.

Service Delivery Enhancements

The HKMC is acutely aware of its need as a service provider to strive for continual improvements in the quality and response of its services while controlling costs, and it worked hard in 2003 to achieve improvements. In this regard, the cost-to-income ratio saw a further improvement to 17.4%, against 23.1% in 2002.

The Corporation made further progress on the development and implementation of standardized mortgage origination documents, a process that has brought increases in efficiency and customer service not only to the HKMC itself but to the wider market. Encouraged by this success, during 2003 the HKMC developed the remaining mortgage origination documents covering three-party mortgage and ancillary documentation, and brought up to date the original model documents in light of developments in law and banking practice since their publication.

To enhance the application process under MIP, in April the HKMC launched a new web-based programme that enables potential homebuyers to obtain a preliminary assessment of the eligibility of their prospective mortgages for insurance coverage under the programme.

The commitment to banks to process MIP applications within two working days was met, but put under strain during the year by the sharp increase in the number of applications. Work is underway to replace the interim MIP processing system MiTracs with a permanent system to enhance capacity and support further automation.

Commitment of Directors and Employees

My fellow directors on the Board have given me their full support and co-operation as we have worked to further the goals of the Corporation and I wish to extend them my thanks. My appreciation also goes to the HKMC's employees, whose dedication ensured that service levels were maintained despite the increased workload and the effects of SARS. Finally, thanks are also due to the HKMC's banking and insurance partners and to those other institutions that have supported its activities, including the Consumer Council, relevant industry associations and regulatory bodies. I look forward to a continuation of these close working relationships as we work towards the further development of the secondary mortgage market to the benefit of all concerned.

Henry Tang
Chairman

Board of Directors

The Honourable
Henry TANG Ying-yen, GBS, JP
Chairman
Financial Secretary

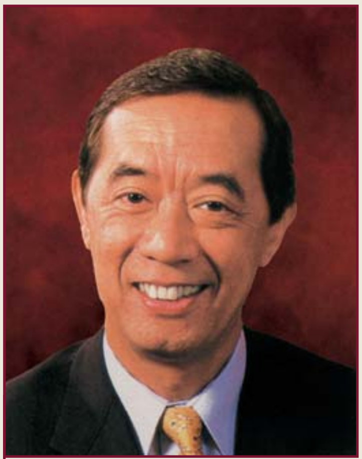
Mr. Joseph YAM Chi-kwong, GBS, JP
Deputy Chairman
Chief Executive
Hong Kong Monetary Authority

The Honourable
Michael SUEN Ming-yeung, GBS, JP
Director
Secretary for Housing, Planning and Lands

The Honourable
Frederick MA Si-hang, JP
Director
Secretary for Financial Services and the Treasury

Mr. Norman CHAN Tak-lam, SBS, JP
Executive Director
Deputy Chief Executive
Hong Kong Monetary Authority

Dr. The Honourable
David LI Kwok-po, GBS, LLD(Cantab), JP
Director
Legislative Councillor
Chairman and Chief Executive of
The Bank of East Asia, Limited



Mr. Ronald Joseph ARCULLI, GBS, JP
Director
Managing Partner of
Arculli and Associates

The Honourable
Bernard Charnwut CHAN
Director
Legislative Councillor
President, Asia Insurance Co. Ltd.

The Honourable
CHAN Kam-lam, JP
Director
Legislative Councillor

The Honourable
SIN Chung-kai
Director
Legislative Councillor

The Honourable
Ambrose LAU Hon-chuen, GBS, JP
Director
Legislative Councillor
Senior Partner of Chu & Lau,
Solicitors & Notaries

Professor Andrew CHAN Chi-fai, Ph.D.
Director
Chairman of Consumer Council
Professor, Department of Marketing and
Director, Executive MBA Programme,
The Chinese University of Hong Kong

Mr. Clifford Rowland FORSTER
Director
Regional Director, Lloyds TSB Bank plc

Mr. Paul A. THURSTON
Director
General Manager Personal Financial Services,
Asia Pacific
The Hongkong and Shanghai Banking
Corporation Limited

Mr. David SUN Tak-kei
Director
Chairman, Assurance & Advisory Business
Services, Ernst & Young

Mr. Brian YIU Chi-pang
Director
Head, Debt Capital Markets, Asian Fixed
Income, Standard Chartered Bank

Management Team

Mr. Peter Pang, JP
Mr. Kenny Fok
Ms. Susie Cheung
Mr. Philip Li
(from left to right)

Mr. Zarino Tong
Ms. Celia Chau
Mr. Paul Ting
Ms. Joyce Wong
Mr. Desmond Cheng
Ms. Angela Leung
Mr. Raymond Luk
Ms. Irene Mok
Mr. Raymond Liu
Mr. Nicholas Chan
(from left to right)

Organization Structure

Chief Executive Officer
Peter Pang

- **Senior Vice President** *(Operations)* Kenny Fok
  - **Vice President** *(Operations)* Irene Mok
  - **Vice President** *(Marketing & Research)* Angela Leung
  - **Vice President** *(Pricing and Credit & Risk Management)* Desmond Cheng
- **Vice President** *(Administration & Human Resources)* Joyce Wong
- **Vice President** *(Internal Audit)* Paul Ting
- **Senior Vice President** *(Finance)* Philip Li
  - **Vice President** *(Information Technology)* Zarino Tong
  - **Vice President** *(Financial Control)* Raymond Luk
  - **Vice President** *(Treasury)* Raymond Liu
- **General Counsel and Company Secretary** Susie Cheung
  - **Legal Counsel** Nicholas Chan
  - **Legal Counsel** Celia Chau

Calendar of Events

9 JANUARY
Increased the programme size of the HK$20 billion Debt Issuance Programme to HK$40 billion

19 MARCH
Launched Phase II of the Project on Standardization of Mortgage Origination Documents

8 APRIL
Sixth Annual General Meeting

22 APRIL
Launched the Mortgage Insurance Programme Preliminary Assessment of Eligibility Programme

23 JUNE
Issued the first 15-year notes under the Debt Issuance Programme

13 AUGUST
Promotion of "One-Stop 90% Mortgage Services"

30 OCTOBER
Signing Ceremony for the issuance of HK$3 billion Series 2003-1 Guaranteed Mortgage-Backed Securities under the Bauhinia MBS Programme through HSBC as Lead Manager and Bookrunner

27 NOVEMBER
Forum on Implementation of the Model Mortgage Origination Documents – Phase II

7 MAY

Established the Transferable Loan Certificate Sub-Programme (TLC Sub-Programme) under the Debt Issuance Programme (DIP) and issued the debut HK$1 billion Transferable Loan Certificate under the TLC Sub-Programme with Bank of China (Hong Kong) as Arranger

21 MAY

Launched the Estate Agents Incentive Scheme for MIP

27 MAY

MIP seminar for members of the Estate Agents Authority

30 MAY

Signing Ceremony – Purchase of Civil Servant Housing Loans

29 NOVEMBER

Coordinated and jointly sponsored a public investment seminar organised by the Hong Kong Capital Markets Association, together with other sponsors including Bank of China (Hong Kong), Citibank, HSBC and Hong Kong Economic Times

2 DECEMBER

Signing Ceremony – Purchase of HK$15.7 billion of Home Starter Loans (HSL) and Sandwich Class Housing Loans (SCHL) from the Government

8 DECEMBER

Issued HK$1.3 billion of Retail Bonds through HSBC as Underwriting Bank and 12 Placing Banks

12 DECEMBER

Participated as speaker in the debt market development forum in Beijing organized by the Institute of Finance and Banking, Chinese Academy of Social Sciences

Business Review

In 2003, the HKMC achieved record-breaking financial results and made further progress in meeting its mandate of developing the secondary mortgage market in Hong Kong. Moreover, it did so in a year in which SARS further dampened an already weak property market, and in which operating conditions generally remained difficult until the final months.

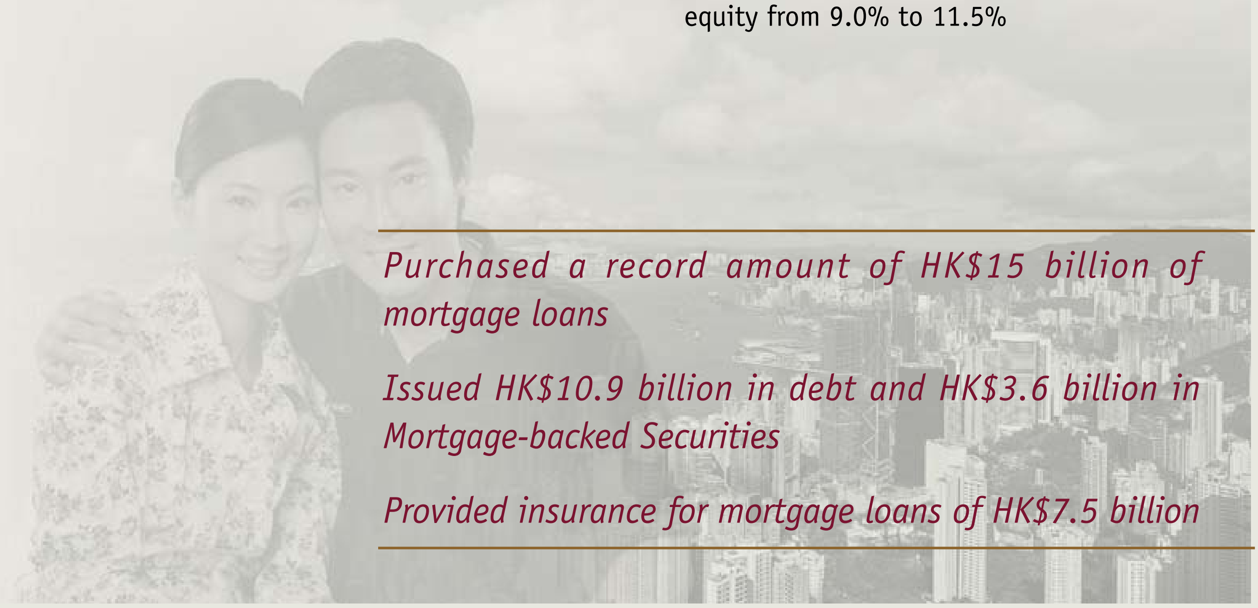
PERFORMANCE HIGHLIGHTS

The HKMC's four business areas of mortgage purchase, mortgage insurance, mortgage securitization and fund raising all performed well in 2003. The major achievements of the HKMC in the year include:

- Purchased a record amount of HK$15 billion of mortgage loans
- Issued HK$10.9 billion in debt and HK$3.6 billion in Mortgage-backed Securities (MBS), maintaining its position as the biggest issuer in the Hong Kong dollar debt market
- Provided insurance for mortgage loans of HK$7.5 billion, 21% higher than in 2002
- Maintained excellent asset quality, with year-end figures of 0.27% and 0.28% for loans overdue more than 90 days in the mortgage portfolio (including mortgage loans with HKMC's guarantee) and mortgage insurance portfolio, respectively, as compared with the industry average of 0.86%
- Maintained its long-term credit ratings at A1/A+ for foreign currency and Aa3/AA- for local currency debt securities from Moody's Investor Service, Inc. (Moody's) and Standard & Poor's (S&P), which are the same levels as those of the Hong Kong SAR Government

These and other achievements underpinned the Corporation's strong financial results:

- Profit after tax of HK$379.1 million, HK$111.8 million or 41.8% more than that in 2002, reflecting the substantial mortgage purchase and low funding cost and a 0.3% increase in the net interest spread on interest-bearing liabilities from 1.3% to 1.6%
- Substantially improved return on shareholder's equity from 9.0% to 11.5%



Purchased a record amount of HK$15 billion of mortgage loans

Issued HK$10.9 billion in debt and HK$3.6 billion in Mortgage-backed Securities

Provided insurance for mortgage loans of HK$7.5 billion

- Improved return on assets from 0.9% to 1.0%
- Maintained a strong capital-to-assets ratio of 7.7%, well above the guideline of at least 5%
- Reduced further the cost-to-income ratio from 23.1% to 17.4%, less than half of the banking industry average of 37.6%

PRODUCT INNOVATION

During 2003, the HKMC again broke new ground in its products and services:

Mortgage Purchase

- Completed the purchase of HK$13.2 billion of public sector loans

Mortgage Insurance

- Launched the Mortgage Insurance Programme (MIP) Preliminary Assessment of Eligibility Arrangement, allowing potential homebuyers to go online and obtain a quick indication of their eligibility for MIP
- Launched the Estate Agents Incentive Scheme for MIP

Mortgage-Backed Securitization

- Issued HK$3 billion MBS with an innovative structure under the Bauhinia Mortgage-Backed Securitization Programme (Bauhinia MBS Programme)

Fund Raising

- Issued the first 15-year notes under the Debt Issuance Programme (DIP)
- Established the Transferable Loan Certificate Sub-Programme (TLC Sub-Programme) under the DIP, and issued the debut HK$1 billion Transferable Loan Certificate
- Reduced the minimum denomination of retail bonds to HK$10,000 from HK$50,000

Service Delivery

- Launched Phase II of the Project on Standardization of Mortgage Origination Documents and introduced a full set of model mortgage origination documents for widespread adoption by banks
- Commenced preparatory work to replace the interim MIP processing system known as Mortgage Insurance Tracking System (MiTracs) with a more powerful MIP permanent system

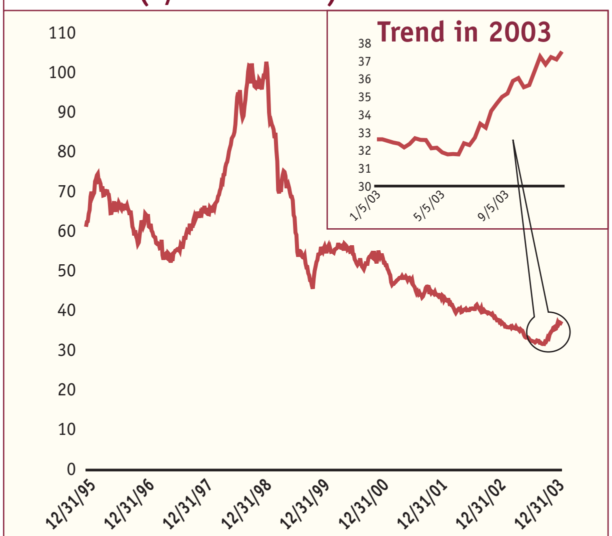
Business Review

REVIEW OF MORTGAGE MARKET

Recovery in Residential Property Market

Hong Kong's residential property market had a volatile year in 2003, remaining weak in the first half but rebounding strongly in the last few months of the year. SARS erupted in March, weighing heavily on the local economy and on residential property prices. Economic growth entered negative territory in the second quarter and the unemployment rate rose to 8.7% in July. Consumer confidence sank to the 35.8 level in April 2003, down from 57.3 in December 2002, according to the Hong Kong Policy Research Institute. Against this economic background, property prices fell sharply. The Centa-City Leading Index, which is a weekly property price index compiled by Centaline Property Agency and City University, dropped to 31.7 in late August, down from 35.8 at the end of 2002 (Figure 1), while only 57,617 Agreements for Sale and Purchase (ASP) were signed in the first three quarters (compared with 67,195 ASP in the last corresponding period), evidencing the sluggish level of property transactions (Figure 2).

Figure 1: Centa-City Leading Index (7/1997 = 100)



Source: Centaline Property Agency and City University

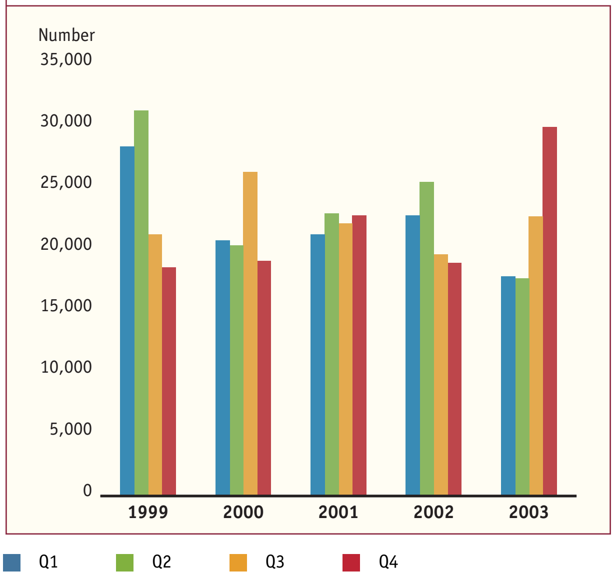
In mid-2003, the property market started to recover, albeit slowly initially. Momentum picked up as a result of several favourable developments, primarily:

- In mid-October the Secretary for Housing, Planning and Lands, Mr. Michael Suen, reiterated the Hong Kong SAR Government's determination to address the imbalance between supply and demand in the property market.
- The Closer Economic Partnership Arrangement (CEPA) between China and Hong Kong was announced, offering further investment opportunities to Hong Kong in the vast China market.
- The Individual Visit Scheme was implemented, allowing eligible Mainland residents to visit Hong Kong as individuals. In the fourth quarter of 2003, the total number of visitors to Hong Kong jumped to 5.17 million, versus 1.65 million in the second quarter.

A strong rally in Hong Kong as well as overseas stock markets, on conclusion of the Iraq War in March/April and the fading of SARS, contributed to the wealth effect locally. Unemployment abated from a peak of 8.7% in July to 7.3% in December (3 months average). GDP climbed 4.0% in the third quarter, versus a 0.5% decline in the SARS-hit second quarter. Most notably, domestic consumption grew 2.0% in 2003, after contracting in the prior two years.

Together, these developments boosted the confidence of homebuyers in Hong Kong. The residential property market rebounded significantly in the last quarter of 2003, with the Centa-City Leading Index reaching 37.1 in the last week of the year, a rise of nearly 17% from the bottom. Transactions surged, with a total sale and purchase level of almost 30,000 cases in the last quarter – the highest for five years (Figure 2). Developers were able to trim aggregate unsold stock to 16,700 units by the year-end, a drop of 26% from the peak of 22, 600 units in March, according to Midland Realty.

Figure 2: Agreements for Sale and Purchase

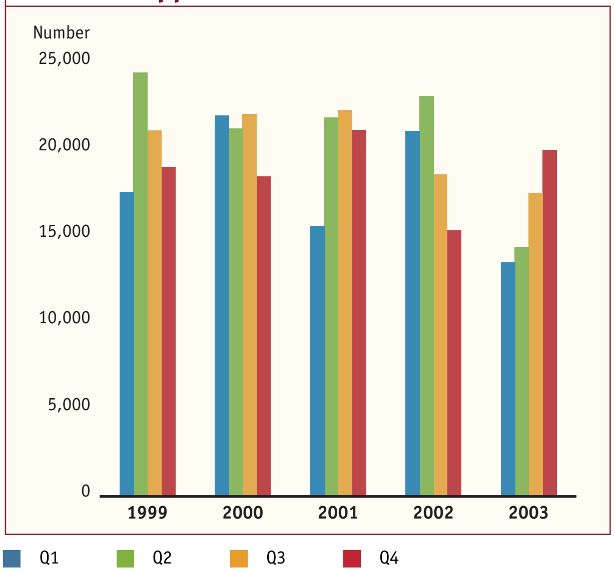


Source: Land Registry

Mortgage Market Swung in Tandem

The mortgage market continued to decline in early 2003, but revived strongly towards the end of the year. According to the Hong Kong Monetary Authority's (HKMA's) monthly survey of residential mortgage lending, total new loans in the first half of 2003 decreased by 36.8% by volume (to 27,771 loans) year-on-year, and by 41.8% by principal amount (to HK$33.2 billion). In the second half, however, total new mortgage loans increased by 10.5% by volume (to 37,332 loans) and by 11.7% by principal amount (to HK$46.3 billion) (Figure 3).

Figure 3: Number of New Mortgage Loans Approved



Source: HKMA

For 2003 as a whole, total new mortgage loans decreased by 16.3% to 65,103, and dropped by 19.3% by principal amount to HK$79.5 billion. At the year-end, total outstanding residential mortgage loans amounted to HK$522.2 billion, a small decrease of 2.2% on the previous year. Of the new loans approved during the year, 49.3% related to new housing units, compared with 47.1% in 2002, reflecting the continuing dominance of the primary market (Figure 4).

Figure 4: Breakdown of Newly-Approved Mortgage Loans

	2002 HK$m	2003 HK$m	Change	Share 2002	Share 2003
Primary	50,881	41,855	-17.7%	47.1%	49.3%
Secondary	39,383	29,915	-24.0%	36.5%	35.3%
Refinancing	17,659	13,024	-26.2%	16.4%	15.4%
	107,924	84,794			

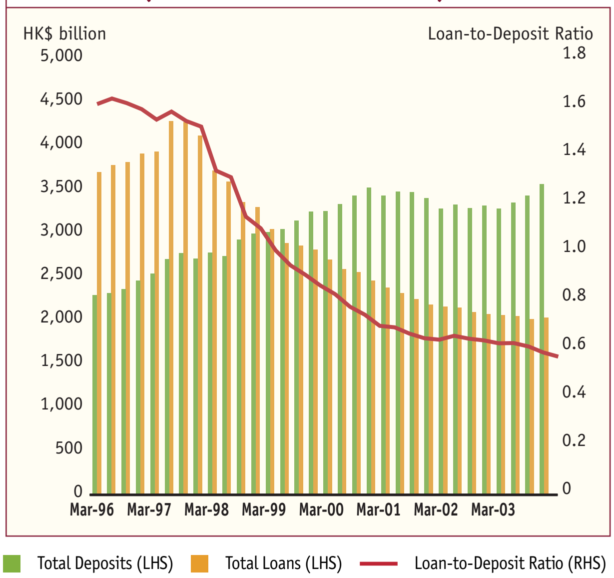
Source: HKMA

Business Review

Low Interest Rates Enhance Returns on Mortgage Loans to Banks

Low interest rates allowed banks to be highly competitive in originating new mortgage loans, at a time when loan demand from other economic sectors remained lukewarm. Loans for corporate use remained flat, while non-mortgage advances to individuals slipped by 4.5% in 2003. The total loan-to-deposit ratio drifted to below 60% (Figure 5).

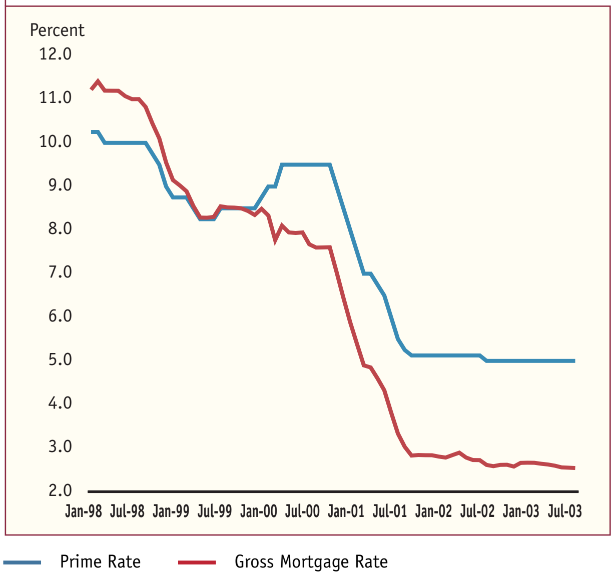
Figure 5: Total Loans and Deposits (Mar-1996 to Dec-2003)



Source: HKMA and CEIC

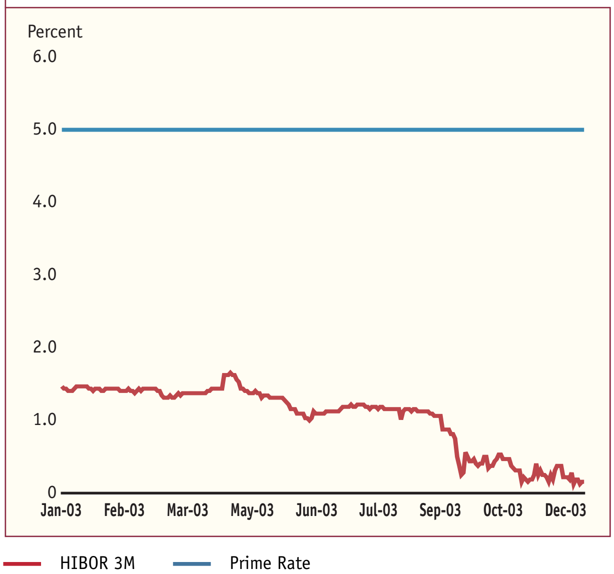
Mortgage loans continued to offer an attractive risk-adjusted return for lenders relative to other categories of loans. With the unemployment rate easing, the number of bankruptcy cases dropped to 22,092 in 2003, the first decline for nine years. Accordingly, the 90-day delinquency ratio of mortgages declined to 0.86% at the end of December 2003, from 1.06% in December 2002. Although keen competition depressed yields, mortgage loans still delivered attractive returns to banks as ample liquidity in financial markets widened the gap between the Prime rate and 3-month HIBOR (an index of funding costs for the banks) to 477 basis points in December 2003, from 356 basis points in January 2003 (Figures 6 & 7).

Figure 6: Prime and Gross Mortgage Rates in Hong Kong



Source: HKMA and HKMC

Figure 7: Trend of Prime Rate and HIBOR in 2003

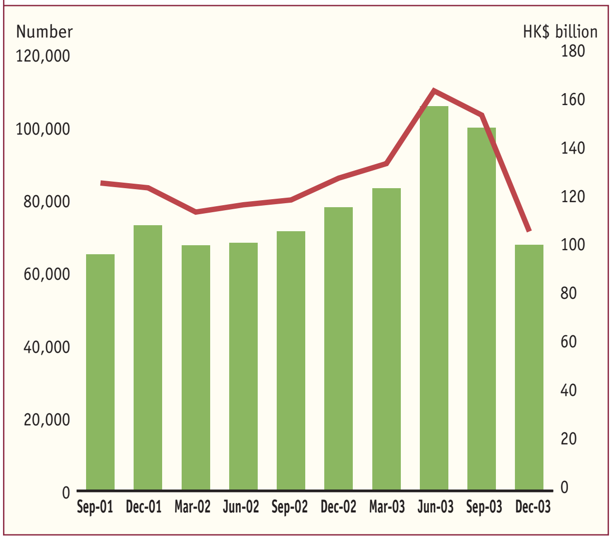


Source: Bloomberg

Asset Quality Improved in the Mortgage Market

With the economy turning around in the latter half of 2003, confidence returned to the residential property market. Not only did this enhance the capital value of local properties, but also it significantly reduced the number of mortgage loans in negative equity. According to the survey conducted by the HKMA, the number of homeowners in negative equity decreased by 32.3% to 67,575 cases at end-December 2003, around the same level as in September 1999, when the survey was first conducted (Figure 8). Mortgage loans in negative equity amounted to a total outstanding principal balance of HK$107 billion, or 20% of all mortgages outstanding at the end of December 2003. With delinquency rates for mortgage loans improving, coupled with this sharp fall in negative equity, the quality of the mortgage portfolios held by Hong Kong banks has improved substantially.

Figure 8: Negative Equity Mortgage Loans

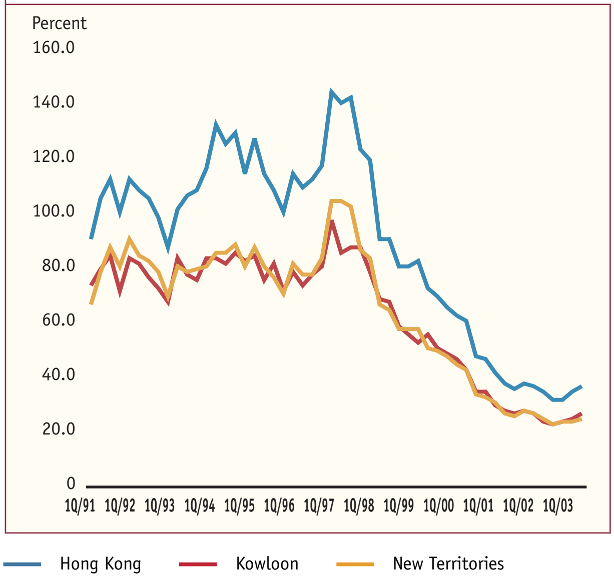


Source: HKMA

Good Affordability and Home-Upgrading to Underpin Demand

Although prices picked up quite strongly in the last few months of 2003, residential properties remain comfortably affordable by standard measures. According to the Rating and Valuation Department, average property prices in the final quarter of 2003 for Class B housing units were about HK$3,000 per square foot on Hong Kong Island, HK$2,200 per square foot in Kowloon and HK$2,000 per square foot in the New Territories, similar to 2002 levels. For Class B properties in Kowloon, for example, the affordability ratio increased only slightly to 27%, though household income slipped slightly (Figure 9). (The higher the ratio, the less affordable.)

Figure 9: Affordability Ratio for Class B Properties



Note: *A rise in the ratio means deterioration in affordability; a fall in the ratio means improvement.*

Assumptions: *The calculation of the ratio uses unit size of 500 sq.ft., mortgage tenor of 20 years and down-payment of 30% of the property value.*

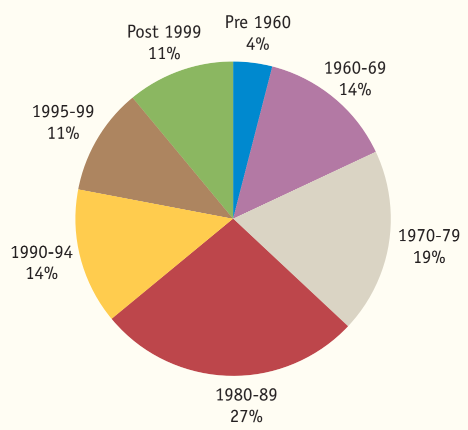
Source: Calculated by the HKMC based on published data from various government departments

Business Review

Demand for residential property will likely be sustained in coming years by homeowners looking to upgrade. At the end of 2003, the stock of private residential units was an estimated 1.12 million units. About 18% of the units, or 206,000 of them, were built before 1970. Another 19%, or 209,000 units, were built in the 1970s. Owners of these relatively old properties are likely to want to upgrade their living conditions, though only when they are confident about their futures financially. With economic prospects improving and property prices affordable, home upgrading should underpin future demand for residential property and thus for mortgage lending (Figure 10).

Figure 10: Age Distribution in year of Private Residential Properties

[as at the end of 2003; Stock = 1.12 million units, estimate]



Source: Rating and Valuation Department

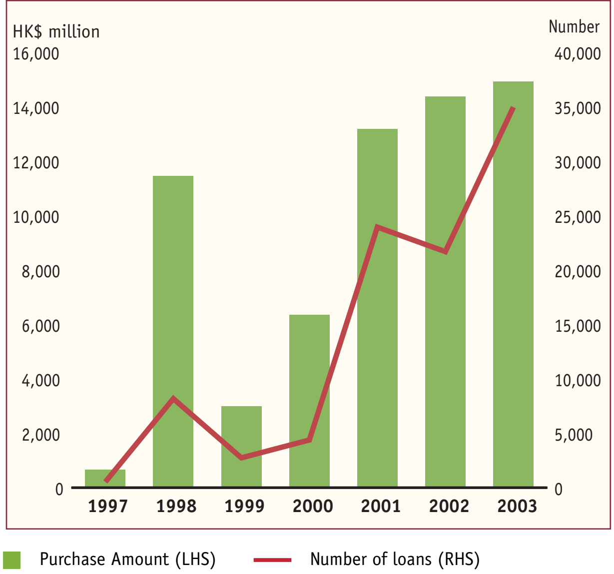
Mortgage Purchase

Purchase Activity

Steady growth in mortgage purchases is crucial to the long-term development of the HKMC as interest income from the retained portfolio accounts for the bulk of its revenues. The acquisition of a steady stream of mortgage portfolios is also a prerequisite for the HKMC to achieve its other business objectives relating to the issuance of debt securities and MBS.

During 2003, the HKMC acquired civil service housing loans and loans under various subsidized housing loan schemes of the Government and its housing agencies, totalling HK$13.2 billion. The purchases from the Government accounted for half of the amount it had targeted to raise from asset disposals during its 2003-2004 financial year to address the fiscal deficit. For the Government housing agencies, this is an efficient means of replenishing funding under their subsidized mortgage schemes. In this way, the agencies support the goal of wider home-ownership among lower-income groups through mortgage financing rather than through building to sell, in line with the Government's revised housing policy. Apart from the purchases from the Government and housing agencies, the Corporation has also purchased a total of HK$1.8 billion from Authorized Institutions and property developers (Figure 11).

Figure 11: Mortgage Purchase Programme of the HKMC

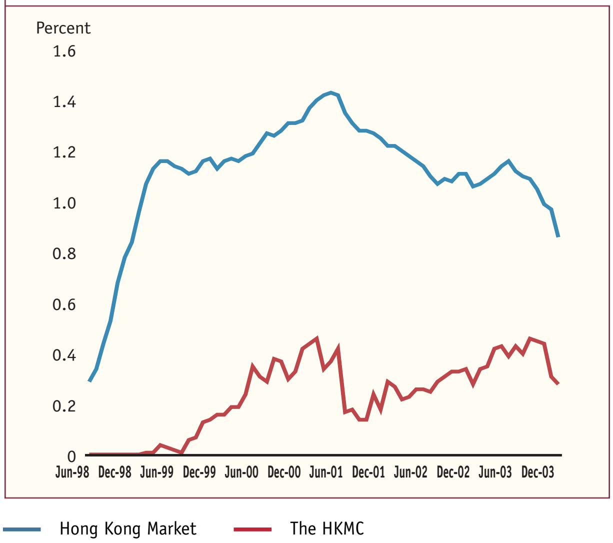


Source: HKMC

Portfolio Quality

Although its retained mortgage portfolio expanded rapidly and credit risks in the market rose, the HKMC maintained a mortgage portfolio of high quality in 2003; evidence of its emphasis on combining growth with prudent risk management. The 90-day delinquency ratio for the retained portfolio (including securitized mortgage loans with the HKMC's guarantee) was 0.27% at the end of December 2003, compared with 0.28% at the end of 2002. This was substantially lower than the 90-day delinquency ratio of 0.86% for the banking industry as a whole at the end of December 2003 (Figure 12).

Figure 12: Delinquency of the HKMC's Mortgage Portfolio* and Mortgage Market in Hong Kong



Note: *Loans overdue for more than 3 months*

* *including mortgage loans with HKMC's guarantee*

Source: HKMA and HKMC

Risk is managed effectively through a four-pronged approach:

- Careful selection of Approved Sellers
- Prudent purchasing criteria
- Effective due diligence review
- Adequate protection for higher risk mortgages

By applying prudent standards and measures, the HKMC has consistently reported a delinquency ratio below that of the industry average since it was formed in 1997.

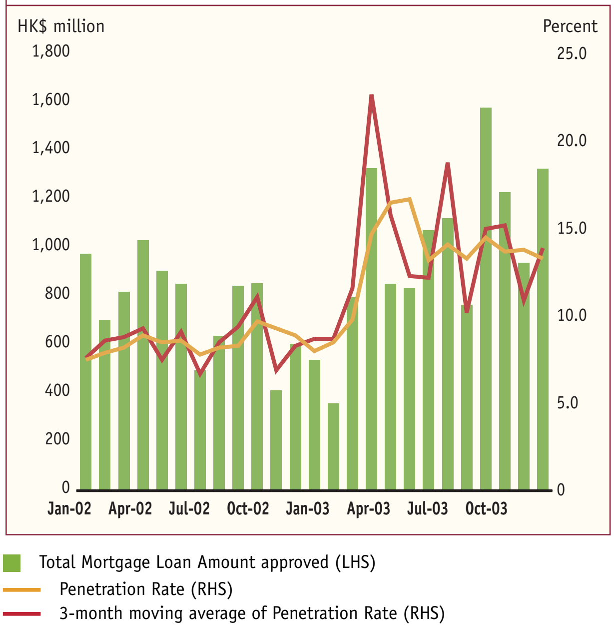
MORTGAGE INSURANCE PROGRAMME

The Mortgage Insurance Programme (MIP) recorded substantially increased business volume in 2003, notably enhancing its penetration rate to 13.5% of new mortgage loans at the end of the year, compared with 8.5% from the previous 12 months (Figure 13). Reasons for the growth include: the introduction of a one-stop 90% mortgage service in December 2002, whereby banks build the insurance premium into the quoted mortgage interest rate, allowing for easier comparisons by prospective borrowers; a web-based system for assessing a potential homebuyer's qualification status for MIP mortgage; an incentive scheme for real-estate agents to promote the MIP; and a marketing campaign launched in July 2003 to enhance public awareness of the MIP and its products.

For the year as a whole, the HKMC received a total of 10,348 applications, involving a total mortgage loan amount of HK$17 billion. This takes to 31,876 the total number of applications received since the programme began in April 1999, for a total mortgage amount of HK$58 billion. The volume of loans drawn down in 2003 increased by 21% as compared to 2002, a result of the rise in residential property transactions during the second half of the year and the increased flexibility of the programme following the introduction of expanded criteria in 2002.

Business Review

Figure 13: Mortgage Loan Amount Approved and Penetration Rate* of MIP



** Penetration Rate = Mortgage Loan Amount approved under MIP/Total Mortgage Loan Amounted approved in the market (according to HKMA's Monthly Mortgage Survey)*

Source: HKMA and HKMC

Preliminary Assessment of Eligibility

In April 2003, the HKMC launched the Preliminary Assessment of Eligibility to enhance the efficiency of the application process under the MIP. This web-based programme enables potential homebuyers to obtain a preliminary assessment of the eligibility of their prospective mortgages for insurance coverage and to identify the MIP product that best fits their needs.

Expansion of the MIP Pilot Scheme

Since the original Pilot Scheme was introduced in April 2002, the HKMC has been able to respond to rapid developments in the residential mortgage market by rolling out new products and expanding the scope of eligible borrowers. To manage the perceived additional credit risks of the Pilot Scheme, the HKMC capped such policies at a certain percentage of the amount at risk of the entire MIP portfolio outstanding and established appropriate reinsurance arrangements with the Approved Reinsurers. To date no delinquencies have been recorded on the new products, contributing to the excellent overall performance of the MIP portfolio.

Development of the MIP

The enhancement in business volume of the MIP is achieved primarily through continuous product innovation and also incessant efforts made by the Corporation to fine-tune programme features and processing efficiency over the years since 1999. The table (Figure 14) shows the product development sequence of the MIP. It can be seen that the Corporation has adopted a gradual expansion approach in the development of MIP in a prudent manner. This approach has proven to be effective and the range of products under the programme has now been enriched to accommodate the varying needs of different borrowers, without creating any noticeable adverse effect on the performance of the loans.

Figure 14: MIP Product Development and Business Initiatives

March 1999	Mortgage loans on completed residential properties with LTV ratio of up to 85% (maximum loan amount of HK$5 million)
August 2000	Mortgage loans on completed residential properties with LTV ratio of up to 90% (maximum loan amount of HK$5 million)
April 2001	Equitable mortgage loans on residential properties under construction with LTV ratio of up to 85% (maximum loan amount of HK$5 million)
July 2001	Equitable mortgage loans on residential properties under construction with LTV ratio of up to 90% (maximum loan amount of HK$5 million)
November 2001	Loan size ceiling increased from HK$5 million to HK$8 million for mortgage loans on completed residential properties with LTV ratio of up to 85%
July 2002	Launch of new product – Deferred Principal Repayment Loans (maximum loan amount of HK$2.5 million)
November 2002	Loan size ceiling increased from HK$5 million to HK$8 million for mortgage loans on residential properties under construction with LTV ratio of up to 85%
November 2002	Update of Deferred Principal Repayment Loans (maximum loan amount of HK$5 million)
December 2002	Launch of "One-stop 90% Mortgage Services"
March 2003	Maximum sum of "remaining term to maturity" and "age of property" at origination and throughout the life of the mortgage loan increased from 40 years to 50 years
April 2003	Launch of web-based MIP Preliminary Assessment of Eligibility
June 2003	Launch of Incentive Scheme for Estate Agents
November 2003	24-hour express approval for MIP applications for specific primary projects

HOME Pilot Scheme

The Home Owner Mortgage Enhancement (HOME) Pilot Scheme was discontinued in April 2003, having achieved its intended effect of alleviating the financial burden on homeowners in negative equity by encouraging banks to lower their mortgage rates. According to HKMA's survey findings, the average interest rate of mortgages in negative equity has reduced from Prime-0.70% as at June 2002 to Prime-0.94% as at December 2003, while the proportion of loans in negative equity paying a mortgage rate of below Prime has increased from 52% as at June 2002 to 57% as at December 2003.

Business Review

MORTGAGE-BACKED SECURITIZATION

Mortgage-backed securities (MBS) provide an efficient means of channelling long-term funds from the capital market to supplement bank financing of mortgage loans. The HKMC and banks can also make use of MBS to manage liquidity and maturity mismatch risks inherent in mortgage loans. A deep and liquid MBS market will further enhance Hong Kong's role as an international financial centre.

MBS provide an important source of funding for the HKMC, as well as being an effective tool for managing the risks of its fast-expanding mortgage portfolio by reducing the Prime-HIBOR basis risk, prepayment risk and refinancing risk. In just six years, the HKMC's mortgage pool has increased to more than HK$34.6 billion, which is funded by debts of a similar amount. Momentum is expected to pick up further with the projected acquisition of about HK$15 billion of mortgage portfolios before the end of 2004.

The HKMC has established two MBS programmes, namely the Guaranteed Mortgage-Backed Pass-Through Securitization Programme (Guaranteed MBS Pass-Through Programme) in October 1999 and the Bauhinia MBS Programme in December 2001.

Guaranteed MBS Pass-Through Programme

Under this programme, a back-to-back structure is adopted in which the HKMC acquires mortgage loans from a bank and sells them directly to a bankruptcy remote special purpose company, the issuer of the MBS. Through securitization under this Programme, banks can convert illiquid mortgage loans into liquid MBS. Furthermore, for capital adequacy requirements, MBS with the HKMC guarantee carry a 20% risk-weighting as opposed to a 50% risk-weighting for mortgage loans, thereby allowing banks to utilize their capital more efficiently. Since inception of the Programme, eight series of MBS have been issued with a total amount of HK$2.8 billion. These include an issue of HK$569 million launched with Fortis Bank in 2003.

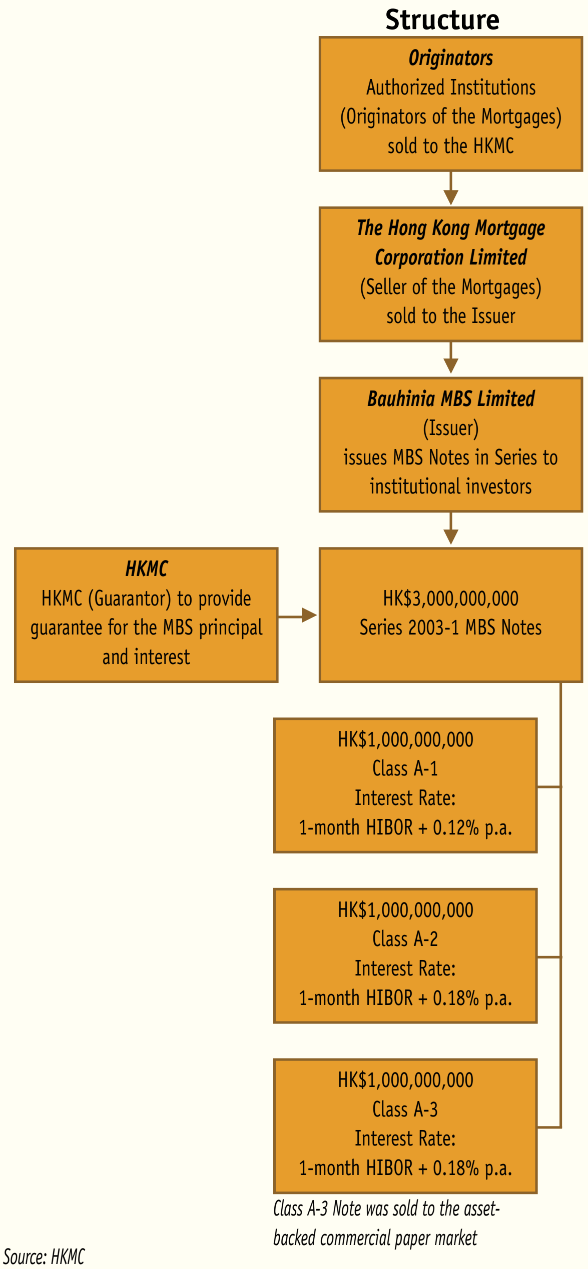
Bauhinia MBS Programme

The Bauhinia MBS Programme is a US$3 billion multi-currency MBS programme established in December 2001. It provides a convenient, flexible and cost-efficient platform for issuing MBS. MBS under the Programme are issued in bond style to facilitate trading in the secondary market. The Programme provides the HKMC with a high degree of flexibility in terms of product structure, credit enhancement and form of offer.

The Programme debut issue with an issue size of HK$2 billion was completed in March 2002. In November 2003, the HKMC successfully securitized HK$3 billion mortgage loans into the Programme's second MBS series, making this the largest-ever Hong Kong dollar denominated residential MBS transaction (Figure 15). This well-received MBS offered an innovative structure, appealing to a wide spectrum of investors, which included institutional investors, fund managers and commercial banks.

Collateralized by a pool of HKMC's high-quality residential mortgages, the second MBS issue was divided into three classes of notes of HK$1 billion each. Each class of the notes was designed to attract a specific group of investor: those focused on stable returns without taking prepayment risk, those prepared to take a higher prepayment exposure in return for a higher investment yield, and those sought further exposure in the highly sophisticated and liquid asset-backed commercial paper market. All three classes of the notes carry the HKMC's guarantee on the principal and interest payments; therefore, they qualify for 20% capital-risk weighting.

Figure 15: Bauhinia MBS Limited HK$3,000,000,000 Series 2003-1 Mortgage-Backed Securities due November 2024 issued under US$3 Billion MBS Programme



Source: HKMC

FUNDING

The HKMC established its DIP with an initial programme size of HK$20 billion in 1998. In view of the very successful performance of the DIP and the continuous growth in the mortgage portfolio, the programme size was doubled to HK$40 billion in January 2003.

During the year, the HKMC raised HK$10.9 billion through 54 issues of debt securities, including the DIP notes and transferable loan certificates issued under the TLC Sub-Programme under the DIP, and issuance of retail bonds. This once again made the HKMC the largest issuer of Hong Kong dollar debt in the year. As at end of the year, the Corporation had 116 issues of debts outstanding for a total amount over HK$36.6 billion (Figure 16).

Figure 16: HKD Debt Capital Market Issuer League Table (2003)

Rank	Issuer	No. of issue	Amount HKD million	Percentage
1	**Hong Kong Mortgage Corporation***	**57**	**13,886**	**7.4%**
2	HBOS	66	11,026	5.9%
3	Westpac Banking Corporation	62	9,499	5.0%
4	Commonwealth Bank of Australia	37	6,040	3.2%
5	Rabobank Nederland	26	6,028	3.2%
6	Australia & New Zealand Banking Group	45	5,936	3.2%
7	Royal Bank of Scotland	28	5,612	3.0%
8	Deutsche Bank	24	4,415	2.3%
9	National Australia Bank	25	4,289	2.3%
10	Bayerische Landesbank	30	4,278	2.3%
	Total of top ten issuers	**400**	**71,009**	**37.8%**
	Others	722	117,054	62.2%
	TOTAL	**1,122**	**188,063**	**100.0%**

Source: HKMC and MCM, including zero coupon bond but excluding commercial papers and Exchange Fund Bills/Notes
*Note: * Included HK$3,000 million mortgage-backed securities issued under Bauhinia MBS Programme*

Business Review

Credit Ratings

The HKMC's ability to attract investors is underpinned by the high credit ratings accorded by S&P and Moody's. Both agencies have re-affirmed the credit ratings of the HKMC, which are the same as those of the Hong Kong SAR Government. Moody's upgraded HKMC's long-term foreign currency rating to A1 from A3 in October, following its upgrade of the Hong Kong SAR Government (Figure 17).

Figure 17: Credit Ratings of HKMC

	S&P		Moody's	
	Short-term	Long-term	Short-term	Long-term
Foreign currency	A-1	A+	P-1	A1
(Outlook)	(stable)	(stable)	(stable)	(stable)
Local currency	A-1+	AA-	P-1	Aa3
(Outlook)	(stable)	(negative)	(stable)	(stable)

According to S&P, "The HKMC has a strong capital base, good asset quality, adequate profitability, and adequate financial flexibility." Further, S&P states, "The quality of HKMC's residential mortgage portfolio is expected to continue to outperform the Hong Kong banking industry average." Moody's notes, "The HKMC's Aa3 long-term local currency debt rating reflects its unique franchise and the solid support it receives from the government".

The HKMC's asset-liability management is well developed within the constraints of the local markets, such as the availability of financial tools and long-term funding, and liquidity is strong. Its risk management policy and approach earned favourable comment: Moody's remarks, "Of specific note is HKMC's strategy to minimize maturities mismatch and basis risk. HKMC's ability to assess and manage risks has resulted in acceptable risk levels well within the Corporation's own guidelines and, in some instances, superior than some of its larger international peers."

HK$9.6 Billion Fund Raised under the DIP

The DIP remains the primary source of funding for the HKMC, with HK$9.6 billion raised through 50 note issues and TLC in 2003. Their tenor generally falls in the range of 1 to 10 years, except the first 15-year note issued in June 2003. These issues brought the total outstanding amount under the DIP to HK$25.9 billion.

As an important development under the DIP, the TLC Sub-Programme was established in May 2003, with a HK$1 billion debut TLC issued. The TLC Sub-Programme helps the HKMC diversify its funding sources and provides it with flexibility in deciding on the timing of drawdown within the specified availability period, making early prepayment, and choosing interest period which helps manage better the maturity of the HKMC's assets and liabilities.

Retail Bonds of the HKMC

The HKMC continued to help develop the retail bond market as an issuer and a pioneer. The HKMC has devoted substantial resources to promoting its debt securities to retail investors. Since the first issue in October 2001, the HKMC has raised HK$7.4 billion through retail bond issuance, accounting for 27% of its debts raised in the same period.

In December 2003, the HKMC issued HK$1.3 billion of retail bonds in four tranches, offering retail investors a wider choice on tenor and return, with the first 7-year retail bonds and more flexible investment amounts, which rose in multiples of HK$10,000 on top of the minimum investment amount of HK$50,000 instead of in multiples of HK$50,000 as previously designed. Retail investors could subscribe for the bonds through 525 bank branches designated by the 12 Placing Banks, or by using phone or Internet banking facilities. To ensure retail investors can liquidate their holdings at any time prior to the maturity of the bonds, the Placing Banks are committed to quoting firm bid prices for the bonds.

Retail bond issues have broadened the HKMC's investor base, and provided the general public with an additional and safe investment choice. Indeed, other companies and financial institutions have enthusiastically embraced this vehicle of financing, with more than HK$38 billion being raised through retail bonds and retail certificates of deposit.

The full potential of the retail bond market cannot be realized without the right distribution channel. We have achieved a major breakthrough by leveraging on the distribution capabilities of the banking system. The mechanism of placing bonds through banks has proven to be highly effective in promoting the sale of bonds to the general public. Through the extensive branch networks and the highly convenient phone and Internet banking facilities of the Placing Banks, and their commitment to make a market for the placed issues, the subscription for and trading of retail bonds are now almost as convenient as placing deposits. The arrangement also presents a win-win solution for the banks. With the current loan-to-deposit ratio at a low level of 57%, the conversion of some of the excess deposits into bonds will help the banks reduce the cost of deposit interest payments and provide them with a new source of fee income by acting as the placing agent and market makers for the issuers.

The retail bond market has considerable potential for growth. More than HK$1.9 trillion is placed in Hong Kong dollar deposits with banks, an indication of the amount the public is prepared to put in assets that produce a stable return.

Developing the Regulatory Framework

The success of the retail bond market was given considerable support by the overhaul of the regulatory framework. Over the past three years, the HKMA, the HKMC and the Hong Kong Capital Market Association worked closely, in consultation with the Government and members of the financial community, to make the regime governing the issuance of such bonds more friendly to issuers and investors.

As the most active Hong Kong dollar debt issuer, the HKMC has been playing an active role in the Working Group for Debt Market Development chaired by the Permanent Secretary for Financial Services and the Treasury. In November 2002, comprehensive comments were submitted on the draft guidelines on debt market reform prepared by the Securities and Futures Commission (SFC).

As a result, the SFC gazetted a new set of guidelines on 21 February that established a new framework for the retail bond market that increases its attraction to corporate issuers. Apart from the relaxation of certain procedural formalities relating to the registration of prospectuses, the guidelines addressed two major areas of interest to the HKMC: the setting up of a "dual prospectus" programme structure and the establishment of a new regime to govern the issuance of offer awareness and summary disclosure materials.

The dual prospectus structure makes it more convenient for frequent issuers to set up a debt issuance programme by first registering a programme prospectus which will be supplemented by shorter issue prospectuses whenever there is a drawdown under the programme. In addition, under the new regime, issuers are now permitted to increase public awareness of an offering by the distribution of publicity materials without the need for specific approval from the SFC, provided that such material conforms to the new guidelines, thus giving more time for the sponsors to prepare for the issue and raise awareness of the new offering.

Business Review

STANDARDIZATION OF MORTGAGE ORIGINATION DOCUMENTS

Further progress was made in the development and implementation of Model Mortgage Origination Documents, a process that has brought increases in efficiency and customer service not only to the HKMC but also to the wider market.

As a frequent buyer of mortgage portfolios, the HKMC has had the opportunity to review the mortgage documents of all the major banks in Hong Kong, which have varied widely in drafting. Standardization enables homebuyers to understand their rights and obligations through documents that reflect best market practice and have the endorsement of the relevant regulators, the legal profession and the Consumer Council.

For mortgage lenders, standardized mortgage origination documents help significantly reduce the time and resources in explaining the terms of the agreements to the borrowers and narrow the scope for disputes arising from misunderstanding.

For the secondary mortgage market, the timeframe and transaction costs are reduced for the sale and purchase of mortgage portfolios, and the issue of MBS, as investors and credit rating agencies no longer need to conduct due diligence on the mortgage origination documents.

Since their launch in November 2001, the original two-party mortgage origination documents have been adopted by 14 major mortgage banks, which together make up around 84% of the residential mortgage market. Encouraged by this success, the HKMC launched the second phase of this project in March 2003. This aimed to produce mortgage origination documents covering three-party mortgage and ancillary documentation, and to bring up to date the original documents in light of developments in law and banking practices.

Once again, this project was aided by the sharing by its members of a clear consensus on fundamental principles, in particular:

- *Firstly*, the documents should strike a fair balance between the rights and obligations of the bank and the borrower, as set out in the Code of Banking Practice developed by the banking associations and endorsed by the HKMA.

- *Secondly*, the documents should be easily understood by the public, cutting out legalese in English and producing a Chinese translation for documents that involve the homebuyers.

- *Thirdly*, any modifications to existing terms and conditions should, as far as possible, avoid undermining the efficiency of normal banking operations.

During October, an extensive consultation exercise was undertaken in which the updated drafts were reviewed by the banking industry associations, the Consumer Council, the two associations representing the legal profession, the Land Registry and the regulators. The final documentation was launched in November at a Forum hosted by the HKMC and attended by over 400 representatives from the banking and legal professions.

NEW INFORMATION TECHNOLOGY

Under Phase II of its Information Technology Strategic Plan, the HKMC is to introduce a permanent replacement for MiTracs. To allow for the swift launch of the MIP, the MiTracs was developed in-house in early 1999. Since then, numerous enhancements have been made to improve processing efficiency, catering for new insurance products introduced and meeting more demanding servicing requirements. With the sharp growth in the number of MIP applications and product diversification, the MiTracs on current trends would reach its maximum capacity in mid-2005.

The HKMC's IT Strategic Study Report, commissioned in 1999, recommended that an Internet-based communication link be established to support straight-through processing of transactions between the HKMC and its business partners, that the IT architecture be overhauled to maximize efficiency and flexibility, and that the old computer systems be migrated to a new platform. Phase I successfully rolled out in March 2002 an Integrated Information Delivery System (IIDS) providing an e-commerce platform linking the HKMC with its business partners in mortgage sales and purchase, mortgage servicing and mortgage insurance.

Phase II, the development of which began in January 2004, aims to migrate the existing MiTracs system to a more robust and maintainable platform and to develop a system to manage the underwriting support documents. New functions also will be introduced to improve the efficiency and productivity of the MIP business, including a credit scoring system and optical character recognition that categorizes underwriting support documents. The new system will roll out in mid-2005.

STAFFING

The HKMC continued to attract, develop and retain professionals with expertise in the secondary mortgage market. The principles of our staffing policy are:

- Maintain a permanent establishment of the minimum size required to function efficiently
- Maximize the use of technology and automation
- Streamline work processes to maximize productivity
- Maintain a cost-to-income ratio below the average of banks and other financial institutions in Hong Kong

HKMC Music Group performing at Po Leung Kuk

The permanent establishment of the Corporation was maintained at 100 in 2003 and will remain unchanged in 2004.

During the year, the HKMC again held in-house and external courses designed to improve the managerial and technical skills of employees. More than 70 courses were offered to cover mortgage securitization, finance, information technology, credit control, and other mortgage-related issues.

Staff attending team building training course

2004 OUTLOOK

The Corporation will continue to further its mission to support the development of Hong Kong's mortgage market through providing additional sources of funding and diversifying risk, in turn widening the scope of available mortgage products and making home ownership more accessible. In pursuit of this goal, we will maintain close working relationships with the banks, insurers, regulators and consumer organizations.

Our specific aims for 2004 include:

- Mortgage purchases maintained at HK$15 billion
- Debt issuance of HK$10 billion, including HK$2 billion of retail bonds
- MBS issuance to reach HK$4 billion
- MIP business value to rise to HK$8 billion
- Maintain quality of assets

Financial Review

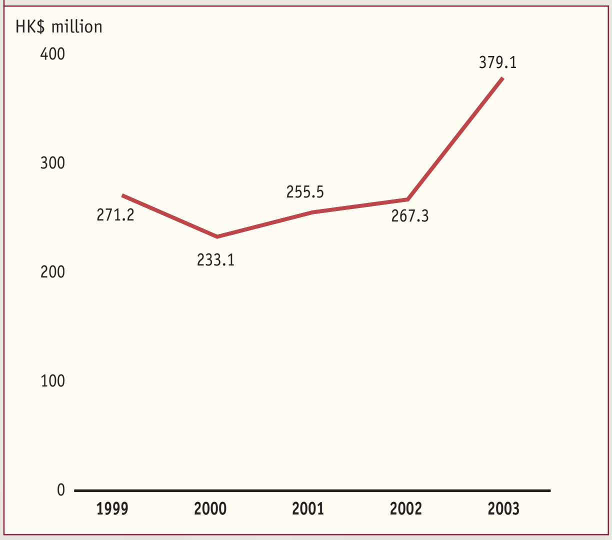
PROFIT AND LOSS ACCOUNT

Operating Results

2003 was a volatile year for business. The Hong Kong economy, including the residential property market, was seriously affected by the outbreak of SARS in March 2003. As a result, gross mortgage loans originated by the Authorized Institutions declined from HK$98.5 billion in 2002 to HK$79.5 billion in 2003. With the fading of SARS and boosted by the announcement of CEPA and the implementation by China of the Individual Visit Scheme, Hong Kong's economy picked up speed in the fourth quarter of 2003. Despite the volatile market conditions in 2003, the Corporation met most of its business targets. These included a record purchase of HK$15 billion of mortgages from the Approved Sellers, issuance of HK$10.9 billion of bonds at a relatively low funding cost, issuance of HK$3.6 billion of mortgage-backed securities under the two MBS programmes, and an increase in the market penetration rate of the mortgage insurance business to 13.5%.

The Corporation recorded a significant growth of 41.8% in profit after tax to HK$379.1 million (2002[1]: HK$267.3 million). Return on shareholder's equity rose sharply to 11.5% (2002[1]: 9.0%) and return on assets improved to 1.0% (2002: 0.9%). Effective cost control and an increase in fee income resulted in a marked improvement in the cost-to-income ratio, which fell from 23.1% in 2002 to 17.4% in 2003. The capital-to-assets ratio remained strong at 7.7% (2002[1]: 9.0%), well above the minimum 5% guideline set by the Financial Secretary.

Profit after taxation



[1] Profit after tax, return on shareholder's equity and the capital-to-assets ratio for 2002 are restated in accordance with SSAP 12 Income Tax issued by the Hong Kong Society of Accountants in August 2002, previously reported at HK$263.8 million, 8.9% and 8.9% respectively.

Net interest income for the year rose by 44.2% from HK$431.0 million to HK$621.4 million. This mainly reflected the significant contribution from the purchase of HK$15 billion of mortgages in 2003 and a favourable net interest spread from the retained mortgage portfolio.

Net Interest Income

	2003 HK$'000	2002 HK$'000
Interest income	**1,006,846**	908,495
Interest expense	**(385,427)**	(477,539)
Net interest income	**621,419**	430,956
Average interest-earning assets	**37,014,673**	28,037,176
Net interest margin	**1.7%**	1.5%
Net interest spread on interest-bearing liabilities [2]	**1.6%**	1.3%

Net interest income for the year rose by 44.2% from HK$431.0 million to HK$621.4 million. This mainly reflected the significant contribution from the purchase of HK$15 billion of mortgages in 2003 and a favourable net interest spread from the retained mortgage portfolio. After inclusion of the interest income contribution from investment in debt securities, the net interest margin of the average interest-earning assets rose from 1.5% in 2002 to 1.7% in 2003.

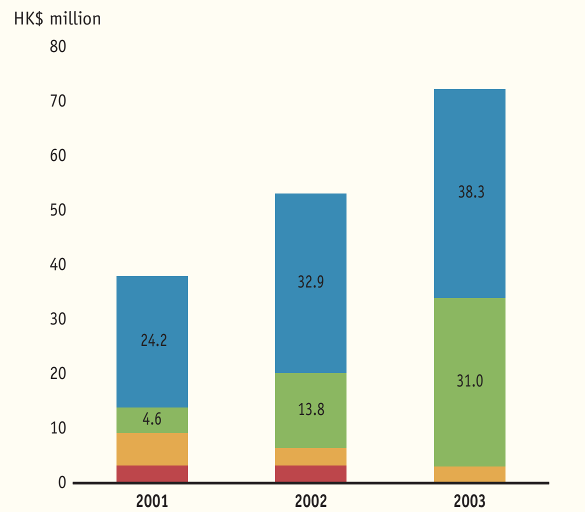
Other Net Income

Other net income increased moderately by 3.6% to HK$60 million in 2003 (2002: HK$57.9 million). The major sources of the income included mortgage insurance premiums and fees income from MBS.

Net mortgage insurance premiums written increased by 24.3% to HK$67.1 million in 2003, reflecting the surge in the market penetration rate from 8.5% to 13.5% in 2003. Net premiums earned for the year increased by 16.4% from HK$32.9 million to HK$38.3 million.

Total fee income generated from the guaranteed MBS business rose by 124.6% from HK$13.8 million to HK$31 million in 2003 as a result of an increase in securitization of the mortgage loans from HK$2 billion to HK$3.6 billion. Early prepayment fees and income from subletting office premises were HK$2.5 million (2002: HK$3.5 million) and HK$0.2 million (2002: HK$2.8 million) respectively in 2003.

Other income



Mortgage insurance net premiums earned
Guarantee fee on MBS
Mortgage prepayment fee
Subletting income

[2] Net interest spread on interest-bearing liabilities = Return on interest-earning assets – Funding cost on interest-bearing liabilities

Financial Review

Operating Expenses

Operating expenses increased moderately by 6.2% from HK$113.3 million to HK$120.3 million in 2003, mainly due to the expansion of business activities. These included the purchases of mortgage loans from the Government and the expansion of bond issuance. Staff costs of HK$68.1 million accounted for 56.6% of the total operating expenses (2002: HK$64.4 million and 56.8%). The permanent establishment of the Corporation increased from 98 to 100 in 2003 to support the increase in business activities. Premises costs, including reinstatement cost of HK$3 million for the existing premises due to office relocation in 2004, increased by HK$3.2 million to HK$17.5 million. Depreciation charges on fixed assets remained stable at HK$14.9 million (2002: HK$14.5 million).

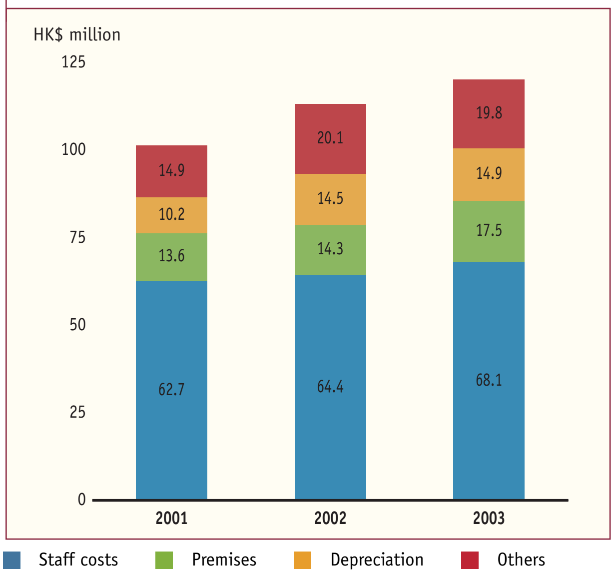
Provisions for Bad and Doubtful Loans

The Corporation made general and specific provisions for bad and doubtful loans of HK$18.2 million and HK$131.2 million respectively in 2003.

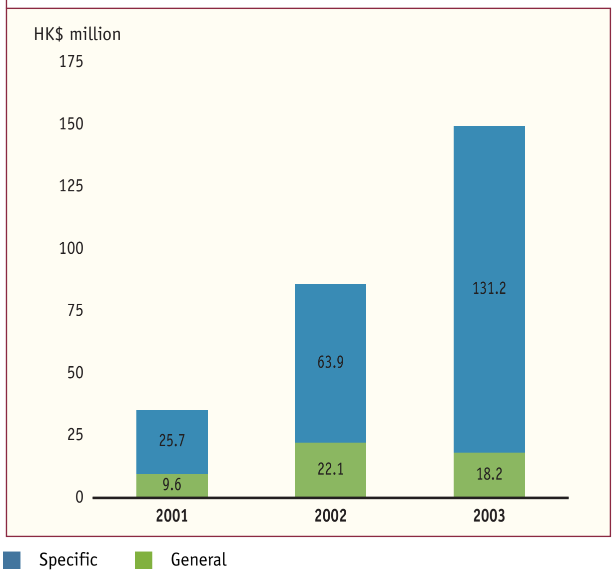
The general provision reduced slightly by HK$3.9 million to HK$18.2 million as a result of the improved credit risk exposure of the retained mortgage portfolio.

An increase in the size of the retained mortgage portfolio, a greater number of personal bankruptcies and the significant decline in property prices as a result of the SARS outbreak were the key factors contributing to the increase in specific loan provisioning from HK$63.9 million in 2002 to HK$131.2 million in 2003.

Operating expenses



Charge for bad and doubtful loans



Mortgage Portfolio, Net

	2003 HK$'000	2002 HK$'000
Gross mortgage portfolio	34,664,075	28,318,693
Accumulated provisions for bad and doubtful loans		
Specific	(13,863)	(9,335)
General	(68,465)	(51,631)
Mortgage portfolio, net	34,581,747	28,257,727

Ratios[3]

	2003	2002
Delinquency ratio for mortgage portfolio overdue for more than 90 days	0.27%	0.28%
Total loan provisions as a percentage of the gross mortgage portfolio	0.24%	0.22%

Total loan provisions accounted for 0.24% of the outstanding principal balance (HK$34.7 billion) of the retained mortgage portfolio at year-end of 2003.

BALANCE SHEET

In 2003, total assets grew by 27% from HK$32.2 billion to HK$40.9 billion. This reflected an increase of HK$6.3 billion in the net mortgage portfolio to HK$34.6 billion, an increase of HK$2 billion in cash and short-term funds to HK$2.2 billion and an increase of HK$0.3 billion to HK$3.5 billion in investment in debt securities.

3 The ratios for 2003 were calculated with an exclusion of those loans overdue for 180 days or more, with collateral repossessed or borrowers having been declared bankrupt, which 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, the delinquency ratio was 0.77% (2002: 0.71%) and loan provisioning was 0.54% (2002: 0.40%) of the outstanding principal balance of the total mortgage loans.

Despite difficult market conditions in 2003, the Corporation was successful in purchasing an aggregate of HK$15 billion of mortgages, HK$0.6 billion more than the total purchases in 2002. The average prepayment rate of the mortgage portfolio (including the securitized mortgages with the Corporation's guarantee) was 8.6% for 2003.

The Corporation has established a set of prudent investment guidelines to invest its surplus funds in approved instruments such as bank deposits and certificates of deposit with a credit rating of at least A-/A3 by S&P or Moody's. The investment portfolio serves as a source of liquidity to support the business operations of the Corporation. As at 31 December 2003, the investment portfolio increased moderately from HK$3.2 billion to HK$3.5 billion.

The Corporation issued a total of HK$10.9 billion of Hong Kong dollar debts in 2003, of which HK$9.6 billion was issued under the DIP and HK$1.3 billion as retail bonds. As at 31 December 2003, the total outstanding balance of the debts issued increased by 28% from HK$28.6 billion to HK$36.6 billion, for the purposes of supporting the significant increase in mortgage purchases and the redemption of HK$2.9 billion of debts maturing in 2003. In order to match the average life of the retained mortgage portfolio with regard to mortgage repayment and prepayment, 67.3% of the debts will mature within the range of 1 to 5 years as at 31 December 2003.

Financial Review

CAPITAL ADEQUACY RATIO

In 2003, the Financial Secretary approved the following revised capital adequacy framework for the Corporation to account for different levels of risk of the financial products under the Mortgage Purchase Programme, the two MBS Programmes and the Mortgage Insurance Programme:

Product	Minimum Capital-to-Assets Ratio
Mortgage Portfolio	
(i) Regular mortgage loans	5% of regular mortgage loan portfolio (based on outstanding principal balance or committed amount)
Loans including	
(ii) HSL and SCHL	2% of the loans (based on outstanding principal balance or committed amount)
Mortgage-Backed Securities (MBS)	2% of MBS portfolio (based on outstanding principal balance)
Mortgage Insurance	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

The capital base, defined as shareholder's equity plus the general provision for bad and doubtful loans, grew by 12.5% from HK$3.2 billion to HK$3.6 billion in 2003. As at 31 December 2003, the aggregate of the on-balance-sheet assets and off-balance-sheet exposure of the Corporation was HK$46.1 billion, mainly consisting of HK$31.2 billion of risk-weighted mortgage loans, HK$3.5 billion of investment in debt securities, HK$1.1 billion of risk-weighted mortgage insurance exposure and HK$2.1 billion of risk-weighted guarantee exposure under the MBS programmes. The capital-to-assets ratio (CAR) was maintained well above the minimum CAR of 5% stipulated by the Financial Secretary at a healthy level of 7.7% (2002: 9.0%) as at 31 December 2003, which is equivalent to 16.6% (2002: 16.6%) calculated in accordance with the capital adequacy framework under the Banking Ordinance.

RISK MANAGEMENT

The active management of risk is an integral part of the Corporation's operations and a key factor in its ability to maintain steady earnings growth. The HKMC is subject to four major areas of risk: interest rate risk, liquidity risk, credit risk and operational risk. The Corporation adopts prudent policies and best market practices in managing these risks in its day-to-day operations.

Interest Rate Risk Management

The HKMC is exposed to interest rate risk because changes in interest rates may affect cash flows of its asset-liability portfolio in a way that adversely affects earnings and stable growth over time. The primary objective of interest rate risk management is therefore to limit potential adverse effects of interest rate movements on net interest income. The specific interest rate risks the HKMC faces are:

1. *Interest Rate Mismatch Risk*

   Interest rate mismatch risk is the most significant type of market risk exposure arising from the Corporation's core businesses. It refers to the potential decline in the net interest income of the Corporation resulting from volatile and adverse movements of market interest rates. Interest rate mismatch risk arises mainly from the difference in the timing of re-pricing of interest rates on the Corporation's assets, liabilities and related derivatives or in the benchmark basis used for setting these rates. For example, the repricing characteristics of the HKMC's interest-earning assets, such as Prime or HIBOR-based mortgage loans, may not exactly match those of its interest-bearing liabilities, such as retail bonds and DIP notes.

The Corporation uses a variety of cash and derivative instruments to manage and hedge its exposure to fluctuations in market interest rates, including interest rate swaps, basis swaps and forward rate agreements, as well as MBS. For example, using interest rate swaps, the HKMC converts its fixed-rate payment liabilities arising from bond issuance to a floating-rate basis, in order to match its floating-rate income from the mortgage assets.

In monitoring and managing interest rate exposure, the HKMC uses duration gap exposure to quantify its earnings-at-risk, which is the potential risk to the net interest income from adverse movements in interest rates. Depending on the prevailing interest rate outlook and market conditions, the Corporation proactively rebalances the duration gap of the asset-liability portfolio under the guidance and supervision of the Asset and Liability Committee (ALCO). The duration gap was kept within three months in 2003.

2. *Basis Risk*

The HKMC is exposed to basis risk as its Prime-based mortgage assets are financed by HIBOR-based liabilities. While there has been a healthy Prime-HIBOR spread, as in the case of Authorized Institutions in Hong Kong, the Corporation currently cannot fully hedge the Prime-HIBOR basis risk. This risk will be more effectively addressed once more mortgages are originated based on HIBOR and as the Prime/HIBOR basis swap market and related risk management instruments become better developed in Hong Kong. Nevertheless, basis risk has been substantially reduced in the case of mortgages acquired from the Government housing agencies, as the Net Required Yield was set by reference to HIBOR. In addition, the Corporation uses the tools of Prime-based MBS issuance, average HIBOR swaps and other derivatives to mitigate the basis risk of its Prime-based mortgage portfolio.

3. *Asset-Liability Maturity Mismatch Risk*

The HKMC faces the risk of a maturity mismatch between assets and liabilities. Despite their typically long contracted maturities, the actual average life of mortgage assets depends on the speed of mortgage prepayment and repayment. Accordingly, the average life of the retained mortgage portfolio shortens when prepayments occur, and the higher the rate of prepayment, the shorter the average life. In Hong Kong, prepayment occurs for two main reasons: housing turnover, when borrowers repay their entire mortgages upon selling their homes; and refinancing, when borrowers refinance their mortgage loans at lower mortgage rates.

The asset-liability mismatch risk can be defined more specifically as reinvestment risk and refinancing risk. Reinvestment risk refers to the risk of reinvesting the proceeds from assets at a lower return, when the actual average life of the assets is shorter than that of the liabilities. Refinancing risk is the risk of refinancing liabilities at a higher cost of funds, when the actual average life of the assets is longer than that of the liabilities.

Financial Review

To contain the reinvestment risk within an acceptable level, the HKMC manages the average life of assets through ongoing purchases of mortgages to replenish its portfolio and through diversifying its investments into high-grade debt securities and cash deposits to adjust the overall average life of its asset pool. To manage the prepayment risk of the retained mortgage portfolio, the Corporation has introduced prepayment fees and issued callable bonds with prepayment options and transferable loan certificates under the DIP.

In managing refinancing risk, the Corporation issues notes across a broad spectrum of maturities from 1 year to 15 years, with a view to achieving the optimal average life for its overall liability portfolio. If necessary, refinancing risk can also be mitigated by adjusting the maturities of assets in the investment portfolio and selectively offloading mortgage assets through securitization.

Liquidity Risk Management

Liquidity risk management refers to the HKMC's ability to repay obligations, including the redemption of debt issues, and to fund committed new mortgage purchases and investments as opportunities arise. The HKMC manages liquidity by monitoring the actual and expected inflow and outflow of funds on a daily basis, by projecting longer-term inflows and outflows across the entire maturity spectrum, and by developing diversified sources of funding with the objective of maintaining stable financing at low funding costs.

The Corporation has secured diversified funding sources to support the future growth of its businesses:

1. Capital: HK$3 billion authorized capital, of which HK$2 billion is paid up and HK$1 billion is available on call from the shareholders.

2. HK$40 billion DIP: the Corporation has appointed 6 Primary Dealers to perform underwriting and market-making activities for public issues drawn under the DIP. A Selling Group consisting of 16 major financial institutions has also been established to broaden the DIP's distribution network. The TLC Sub-Programme established under the DIP helps further diversify funding sources and broaden investor base.

3. Retail Bonds: the Corporation has successfully implemented a new offering mechanism that enables retail investors to subscribe for the HKMC's bonds through placing banks.

4. US$3 billion Bauhinia MBS Programme: the Programme is a multi-currency, bond-style programme for securitization of the HKMC's retained portfolio.

5. Debt Investment Portfolio: the Liquid Debt Investment Portfolio includes bank deposits and high-quality short-term cash equivalent, certificates of deposit, notes and MBS that can be readily converted into cash.

6. HK$10 billion Revolving Credit Facility: the Exchange Fund has provided a HK$10 billion revolving credit facility to the HKMC since January 1998.

7. Money Market Lines: the HKMC has established extensive money market lines with local and international banks for bridge financing. Its "public sector entity" status under the Banking Ordinance gives a 20% risk-weighting treatment for financial institutions investing in the HKMC's debt securities or lending to the Corporation.

Asset and Liability Committee (ALCO)

The HKMC has formed an ALCO to manage its asset-liability portfolio according to prudent risk management principles, with the aim of avoiding excessive risk exposure while maximizing the return for the Corporation. The Committee formulates strategies to achieve the Corporation's risk management, financing, hedging, investment and securitization objectives. It also sets risk limits for the business units and monitors compliance. ALCO is chaired by the Chief Executive Officer and its members include the Senior Vice President (Finance), Senior Vice President (Operations), and senior staff of the Treasury, Financial Control and Pricing and Credit & Risk Management Departments. The Committee holds meetings every week.

ALCO Meeting

Credit Risk Management

Credit risk represents the primary exposure to the risk that the HKMC may not be able to recover amounts due from borrowers. The Corporation has a prudent policy for managing credit risk and adopts a five-pronged approach to maintaining the high asset quality of its mortgage portfolio through:

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

Careful selection of Approved Sellers

The HKMC conducts a due diligence review of the potential sellers of mortgage loans prior to their appointment as Approved Seller/Servicers. The review focuses in particular on the seller's mortgage loan underwriting policies, historical delinquency experiences and loan servicing capabilities. Once approved, Approved Seller/Servicers are subject to periodic review.

Prudent mortgage purchasing criteria

The HKMC adopts prudent mortgage purchasing criteria that confine its purchases to mortgages on owner-occupied properties and to borrowers with a debt-to-income ratio below 50%. Other relevant criteria are in line with best market practices adopted by the banking industry.

Financial Review

Effective due diligence process

As an integral part of the risk management process, the HKMC conducts due diligence review of a sample of acquired mortgage loans before and after their purchase to ensure compliance with the Corporation's mortgage purchasing criteria.

Adequate protection for higher-risk mortgages

For products that involve higher credit risk, such as top-up loans originated by property developers, the HKMC has established credit enhancement arrangements such as repurchase warranties or reserve funds in order to mitigate the additional credit risk involved with these loans.

Credit Committee

The Credit Committee develops and oversees the implementation of the Corporation's policies for managing all aspects of the underlying credit risks of its business. Its major tasks include approving applications to become Approved Seller/Servicers under the MPP and Approved Reinsurers under the MIP. The Committee also sets limits for individual Approved Sellers and Approved Reinsurers and counterparty limits for treasury activities and reviews the Corporation's mortgage purchasing criteria.

The Credit Committee is chaired by the Chief Executive Officer and its members include the Senior Vice President (Finance), Senior Vice President (Operations), General Counsel and senior staff of the Operations and Finance Divisions.

Pricing Committee

The Pricing Committee meets weekly in conjunction with the ALCO to review the pricing for various products under the MPP, MBS Programmes and MIP in light of latest market conditions and business strategies. It also reviews all risk-based pricing transactions prior to submission to the Executive Directors for final approval.

Stress Test

In light of the substantial increase in business volume the Corporation has taken additional steps to ensure that its credit and interest rate risk exposures are monitored in a timely and effective manner. The Corporation conducts a stress test on a quarterly basis using the framework introduced by the HKMA to test the resilience of Authorized Institutions under adverse economic conditions. The results provide a confirmation that the Corporation will remain solvent even under the most severe interest rate and credit risk scenarios prescribed in the HKMA guidelines.

Operational Risk Management

Operational risk is the potential for losses which may arise from internal operation activities and external events. The HKMC seeks to mitigate this by maintaining a comprehensive system of internal controls to manage the operational risk of its business units. To ensure adequate compliance, the Corporation's key operating systems and procedures are subject to regular audit and review by both internal and external auditors.

To reduce possible errors due to human intervention, the HKMC applies extensive technology solutions to its business operations, including those based on the Internet. The Corporation has established a comprehensive disaster recovery plan, including the establishment of an offsite back-up centre, to ensure that its IT systems can continue operating even in the event of a core system's failure or other unexpected major events.

Audit Committee

The Audit Committee plays a central role in assisting the Board of Directors to fulfill its corporate governance and oversight responsibilities in relation to the HKMC's financial reporting, internal control structure, business policies and practices, as well as internal and external audit functions. Members of the Audit Committee are responsible to ensure that the intended systems of internal control, checks and balances are properly implemented, and that checking procedures are constantly upgraded to match changes in the business.

Appointed by the Board, the HKMC Audit Committee comprises not less than four Directors, one of whom must be an Executive Director. The Committee is currently chaired by Dr. David Li and its members include Mr. Ronald Arculli, Mr. David Sun and Mr. Norman Chan. The Committee met twice in 2003 to review the financial accounts and other ongoing audit work of the internal and external auditors.

Audit Committee Meeting

Report of the Directors

The Directors have pleasure in presenting their report together with the audited financial statements of the Company and HKMC Mortgage Management Limited (together the "Group") for the year ended 31 December 2003.

PRINCIPAL ACTIVITIES

The principal activities of the Company are:

(1) to purchase portfolios of mortgage loans, secured by residential properties situated in Hong Kong from approved sellers, including authorized institutions authorized under the *Banking Ordinance* of Hong Kong (Authorized Institutions), subsidiaries or affiliated companies of Authorized Institutions, government bodies and agencies and related organizations, statutory bodies, public bodies, property developers, and any financing entity affiliated to such property developer;

(2) to raise financing for its purchase of mortgage loans through the issuance of debt securities to banks, institutional and retail investors;

(3) to securitize mortgage portfolios through special purpose companies by way of issuing mortgage-backed securities to investors; and

(4) to provide mortgage insurance cover to Authorized Institutions in respect of mortgage loans originated by such Authorized Institutions and secured by residential properties.

The corporate information and principal activities of the subsidiary are shown in Note 19 to the financial statements.

RESULTS AND APPROPRIATIONS

The results of the Group for the year ended 31 December 2003 are set out in the consolidated profit and loss account on page 43.

The Directors do not recommend the payment of a dividend.

RESERVES

Movements in the reserves of the Group and the Company during the year are set out in Note 28 to the financial statements.

FIXED ASSETS

Details of the movements in fixed assets of the Group and of the Company during the year are set out in Note 18 to the financial statements.

DEBT SECURITIES ISSUED

The Company issued notes to banks and institutional investors under its HK$40 billion Debt Issuance Programme (DIP) and also offered notes to retail investors through various placing banks during the year ended 31 December 2003, totalling HK$10,885,540,000, for the purposes of providing general working capital and refinancing, at the total consideration of HK$10,869,845,000. Details of the debt securities issued and redeemed are set out in Note 23 to the financial statements.

DIRECTORS

The Directors of the Company who served during the period were as follows:

The Honourable Henry TANG Ying-yen, GBS, JP
Chairman and Executive Director
(appointed on 5 August 2003)
Mr. Antony LEUNG Kam-chung, GBS, JP
Chairman and Executive Director
(resigned with effect from 17 July 2003)
Mr. Joseph YAM Chi-kwong, GBS, JP
Deputy Chairman and Executive Director
Mr. Norman CHAN Tak-lam, SBS, JP
Executive Director
Mr. Tony LATTER, JP
Executive Director
(resigned with effect from 4 January 2003)
Mr. Ronald Joseph ARCULLI, GBS, JP
Director
The Honourable Bernard Charnwut CHAN, JP
Director
Professor Andrew CHAN Chi-fai, Ph.D.
Director
The Honourable CHAN Kam-lam, JP
Director (appointed on 8 April 2003)
The Honourable CHAN Kwok-keung, JP
Director (retired on 8 April 2003)
Mr. Clifford Rowland FORSTER
Director
Mr. Stephen IP Shu-kwan, GBS, JP
Director (appointed on 17 July 2003 and resigned on 5 August 2003)
Mr. LAM Yim-nam
Director (retired on 8 April 2003)
The Honourable Ambrose LAU Hon-chuen, GBS, JP
Director (appointed on 8 April 2003)
Dr. the Honourable David LI Kwok-po, GBS, LLD (Cantab), JP
Director
The Honourable Frederick MA Si-hang, JP
Director
The Honourable SIN Chung-kai
Director
The Honourable Michael SUEN Ming-yeung, GBS, JP
Director
Mr. David SUN Tak-kei
Director
Mr. Paul THURSTON
Director (appointed on 8 April 2003)
Mr. Brian YIU Chi-pang
Director

In accordance with Article 109 of the Company's Articles of Association, all those Directors who are not Executive Directors shall retire but shall be eligible for re-election at the next annual general meeting.

DIRECTORS' INTERESTS IN TRANSACTIONS AND CONTRACTS

The following Directors may be deemed to be interested in any contracts which have been entered, or may be entered, into by the Company for the reasons set out below:

(1) The Hon. Henry Tang is the Financial Secretary as Controller of the Exchange Fund. Mr. Joseph Yam is the Monetary Authority appointed by the Financial Secretary under the Exchange Fund Ordinance. The Monetary Authority acted as the arranger, agent and operator in respect of the Company's HK$20 billion Note Issuance Programme (NIP) until 31 August 2001. The Monetary Authority also acts as the custodian and clearing agent for the DIP. On 27 January 1998, the Company entered into an agreement with the Monetary Authority through which the Exchange Fund has provided a HK$10 billion

revolving credit facility to the Company. At 31 December 2003, there was no outstanding balance. The HKMC purchased around HK$10.5 billion of mortgages from the Government of the Hong Kong Special Administrative Region (the "Government") up to 31 December 2003.

(2) Mr. Ronald Joseph Arculli is a director of Sino Land Company Limited. The Company purchased a total of HK$715 million of mortgage loans from 9 affiliated companies of Sino Land Company Limited up to 31 December 2003.

(3) Dr. the Hon. David Li is the Chairman and Chief Executive of The Bank of East Asia, Limited which is (a) a selling group member under the DIP; (b) an Approved Seller/Servicer under the Mortgage Purchase Programme (MPP); (c) an approved Authorized Institution under the Mortgage Insurance Programme (MIP); (d) a placing bank in the Company's retail note issuance in November 2003; (e) a senior co-lead manager in the Series 2003-1 issue of the Company's US$3 billion Mortgage-Backed Securitization Programme (Bauhinia MBS Programme); and (f) an approved Authorized Institution under the Home Owner Mortgage Enhancement Programme (HOME Programme). Dr. Li is also a director of Tricor Holdings Limited which is the holding company of Tengis Limited, the corporate services provider of HKMC Funding Corporation (1) Limited, a special purpose entity formed for the purposes of the Guaranteed Mortgage-Backed Pass-Through Securitization Programme.

(4) The Hon. Bernard Chan is a director of Asia Commercial Bank Limited which is (a) an Approved Seller/Servicer under the MPP; (b) an approved Authorized Institution under the MIP; and (c) an approved Authorized Institution under the HOME Programme. He is also a director of Asia Insurance Company, Limited which is an approved reinsurer under the MIP.

(5) The Hon. Frederick Ma is the Secretary for Financial Services and the Treasury of Hong Kong and the Hon. Michael Suen is the Secretary for Housing, Planning and Lands of Hong Kong. Both Mr. Ma and Mr. Suen are members of The Hong Kong Housing Authority which is an Approved Seller/Servicer under the MPP from which the Company purchased mortgage loans of around HK$20.6 billion up to 31 December 2003. The Company purchased around HK$10.5 billion of mortgages from the Government up to 31 December 2003.

(6) Mr. David Sun is a Partner of Ernst & Young which acts as consultant to Merrill Lynch Reinsurance Solutions Ltd. (ML Re). The Company entered into reinsurance arrangements with ML Re in July 2002 under the HOME Programme in which ML Re acts as the arranger and reinsurer to the HKMC under it.

Except for the above disclosure and the related party transactions as stated in Note 27 to the financial statements, no contracts of significance in relation to the Company's business to which the Company was a party and in which any of the Directors or members of its management had a material interest, either directly or indirectly, subsisted at the end of the year or at any time during the year.

At no time during the year was the Company a party to any arrangement to enable any of its Directors or members of its management to acquire benefits by means of the acquisition of shares in, or debt securities of, the Company or any body corporate.

ADDITIONAL DISCLOSURES IN COMPLIANCE WITH THE PROVISIONS OF THE INSURANCE COMPANIES ORDINANCE (ICO)

The Controllers of the Company as defined in the ICO are the Hon. Henry Tang and Mr. Pang Sing-tong. Mr. Tang is the Chairman of the Company. Mr. Pang is the Chief Executive Officer of the Company, and he did not have any interests in the transactions or the contracts which the Company had entered into during the year ended 31 December 2003.

The Company has not carried on insurance business relating to liabilities or risks in respect of which persons are required by any Ordinance to be insured.

The Company operates its mortgage insurance business on a risk-sharing basis, and retains up to 50% of the risk exposure under its mortgage insurance covers with the remaining risk exposure being ceded to its approved reinsurers. The Company has entered into reinsurance arrangement with the following approved reinsurers: Asia Insurance Company, Limited, Hang Seng Insurance Company, Limited, HSBC Insurance (Asia) Limited, PMI Mortgage Insurance Co. and United Guaranty Mortgage Indemnity Company.

Under the Company's HOME Programme, the Company retains 50% of risk exposure under its mortgage insurance cover with the remaining risk exposure being ceded to ML Re.

HKMC Mortgage Management Limited is a wholly-owned subsidiary of the Company as set out in Note 19 to the financial statements.

AUDITORS

The accounts have been audited by PricewaterhouseCoopers who retire and, being eligible, offer themselves for re-appointment.

On behalf of the Board of Directors

Henry Tang
Chairman

Hong Kong,
1 April 2004.

Report of the Auditors

AUDITORS' REPORT TO THE SHAREHOLDER OF THE HONG KONG MORTGAGE CORPORATION LIMITED (INCORPORATED IN HONG KONG WITH LIMITED LIABILITY)

We have audited the financial statements on pages 43 to 79, which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The Hong Kong Companies Ordinance requires the directors to prepare financial statements which give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you, as a body, in accordance with section 141 of the Hong Kong Companies Ordinance, and for no other purpose. We do not assume responsibilities towards or accept liability to any other person for the content of this report.

BASIS OF OPINION

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the circumstances of the Company and the Group, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

OPINION

In our opinion the financial statements give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 2003 and of the profit and cash flows of the Group for the year then ended and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

PricewaterhouseCoopers

PricewaterhouseCoopers
Certified Public Accountants

Hong Kong,
1 April 2004.

Consolidated Profit and Loss Account

For the year ended 31 December 2003

	Notes	2003 HK$'000	2002 HK$'000 Restated
Interest income	3	**1,006,846**	908,495
Interest expense	4	**(385,427)**	(477,539)
Net interest income		**621,419**	430,956
Other income, net	5	**59,965**	57,917
Operating income		**681,384**	488,873
Operating expenses	6	**(120,304)**	(113,330)
Operating profit before provisions		**561,080**	375,543
Provisions for bad and doubtful loans	7	**(149,370)**	(86,054)
Operating profit		**411,710**	289,489
Net gain on disposal of investment in debt securities	8	**11,348**	2,580
Profit before taxation		**423,058**	292,069
Taxation	9(a)	**(43,922)**	(24,722)
Net profit for the year	11	**379,136**	267,347

Consolidated Balance Sheet

As at 31 December 2003

	Notes	2003 HK$'000	2002 HK$'000 Restated
ASSETS			
Cash and short-term funds	12, 20	**2,219,346**	212,863
Interest and remittance receivables	13	**297,842**	310,551
Prepayments, deposits and other assets	14	**210,808**	110,755
Deferred expense, net	15	**26,646**	21,876
Mortgage portfolio, net	16	**34,581,747**	28,257,727
Investment in debt securities	17, 20	**3,535,525**	3,244,520
Fixed assets	18	**19,088**	28,323
Deferred tax assets	9(b)	**9,300**	4,418
		40,900,302	32,191,033
LIABILITIES			
Interest payable	21	**257,663**	223,122
Accounts payable, accrued expenses and other liabilities	22	**390,612**	136,079
Tax payable	9(b)	**17,778**	18,608
Unearned premiums	10	**106,043**	79,444
Debt securities	20, 23	**36,630,290**	28,615,000
		37,402,386	29,072,253
SHAREHOLDER'S EQUITY			
Share capital	25	**2,000,000**	2,000,000
Retained profits	28	**1,469,259**	1,102,803
Contingency reserve	28	**28,657**	15,977
		3,497,916	3,118,780
		40,900,302	32,191,033

Yam Chi-kwong, Joseph
Deputy Chairman

Chan Tak-lam, Norman
Executive Director

Balance Sheet

As at 31 December 2003

	Notes	2003 HK$'000	2002 HK$'000 Restated
ASSETS			
Cash and short-term funds	12, 20	**2,219,346**	212,863
Interest and remittance receivables	13	**297,842**	310,551
Prepayments, deposits and other assets	14	**210,808**	110,755
Deferred expense, net	15	**26,646**	21,876
Mortgage portfolio, net	16	**34,581,747**	28,257,727
Investment in debt securities	17, 20	**3,535,525**	3,244,520
Investment in a subsidiary	19	**33**	30
Fixed assets	18	**19,088**	28,323
Deferred tax assets	9(b)	**9,300**	4,418
		40,900,335	32,191,063
LIABILITIES			
Interest payable	21	**257,663**	223,122
Accounts payable, accrued expenses and other liabilities	22	**390,594**	136,079
Tax payable	9(b)	**17,778**	18,608
Unearned premiums	10	**106,043**	79,444
Debt securities	20, 23	**36,630,290**	28,615,000
		37,402,368	29,072,253
SHAREHOLDER'S EQUITY			
Share capital	25	**2,000,000**	2,000,000
Retained profits	28	**1,469,310**	1,102,833
Contingency reserve	28	**28,657**	15,977
		3,497,967	3,118,810
		40,900,335	32,191,063

Yam Chi-kwong, Joseph
Deputy Chairman

Chan Tak-lam, Norman
Executive Director

Consolidated Statement of Changes in Equity

For the year ended 31 December 2003

	Notes	2003 HK$'000	2002 HK$'000 Restated
Total equity as at 1 January, as previously reported	28	**3,109,819**	2,846,010
Effect of adopting SSAP 12	2(f)	**8,961**	5,423
Total equity as at 1 January, as restated		**3,118,780**	2,851,433
Net profit for the year	28	**379,136**	267,347
Total equity as at 31 December	28	**3,497,916**	3,118,780

Consolidated Cash Flow Statement

For the year ended 31 December 2003

	Notes	2003 HK$'000	2002 HK$'000
Net cash outflow from operating activities	26	**(5,697,395)**	(8,058,702)
Investing activities			
Purchase of fixed assets		**(5,660)**	(10,799)
Purchase of investment in debt securities		**(1,551,254)**	(2,290,843)
Proceeds from redemption of investment in debt securities		**1,261,197**	781,334
Net cash outflow from investing activities		**(295,717)**	(1,520,308)
Net cash outflow before financing		**(5,993,112)**	(9,579,010)
Financing			
Proceeds from issue of debt securities		**10,869,845**	14,935,133
Redemption of debt securities		**(2,870,250)**	(6,400,000)
Net cash inflow from financing		**7,999,595**	8,535,133
Increase/(decrease) in cash and cash equivalents		**2,006,483**	(1,043,877)
Beginning cash and cash equivalents		**212,863**	1,256,740
Ending cash and cash equivalents		**2,219,346**	212,863
Analysis of the balance of cash and cash equivalents			
Cash and short-term funds	12	**2,219,346**	212,863

Notes to the Financial Statements

1. BASIS OF PREPARATION

The financial statements of The Hong Kong Mortgage Corporation Limited (the "Company") and its subsidiary, HKMC Mortgage Management Limited, (collectively the "Group") have been prepared under the historical cost convention, and in accordance with the provisions of the Hong Kong Companies Ordinance and accounting principles generally accepted in Hong Kong.

2. PRINCIPAL ACCOUNTING POLICIES

a. Consolidation

The consolidated accounts include the accounts of the Company and its subsidiary made up to 31 December. A subsidiary, in accordance with the Hong Kong Companies Ordinance, is a company in which the Company, directly or indirectly, holds more than half of the issued share capital, or controls more than half of the voting power, or controls the compositions of the Board of Directors. In the Company's balance sheet, an investment in a subsidiary is stated at cost less any impairment losses.

All significant intercompany transactions and balances within the Group are eliminated on consolidation.

b. Adoption of Statements of Standard Accounting Practice (SSAPs)

In the current year, the Group has adopted the following SSAPs issued by the Hong Kong Society of Accountants which are effective for accounting periods commencing on or after 1 January 2003:

SSAP 12:	Income taxes
SSAP 34 (revised):	Employee benefits

The effects of adopting the new SSAP 12 has been shown on the respective notes to the accounts. There were no material effects on net profit and opening balance of retained profit for the current year and prior year from the adoption of SSAP 34.

c. Income and expense recognition

Provided it is probable that the economic benefits associated with a transaction will flow to the Group and the income and costs, if applicable, can be measured reliably, interest income, interest expense and others are recognized on the following bases:

(i) Interest income and expense

Interest income and expense are accrued on a time-apportioned basis on the principal outstanding and at the rate applicable, except in case of bad and doubtful loans (Note 2(h)).

(ii) Fee income and expense

Fee income and expense are recognized when earned or incurred.

d. Fixed assets and depreciation

Fixed assets are stated at cost less accumulated depreciation. The cost of an asset comprises its purchase price and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditure incurred after the fixed assets have been put into operation, such as repairs and maintenance and overhaul costs, is normally charged to the profit and loss account in the year in which it is incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of fixed assets, the expenditure is capitalized as an additional cost of the fixed asset.

Depreciation is calculated on a straight-line basis at annual rates estimated to write off the cost of each asset over its expected useful life.

The annual rates are as follows:

Leasehold improvements	over the unexpired period of the lease
Furniture and fixtures	over the unexpired period of the lease
Computer and related software	33-1/3%
Office equipment	33-1/3%
Motor vehicle	25%

At each balance sheet date, both internal and external sources of information are considered to assess whether there is any indication that furniture and equipment and other fixed assets are impaired. If any such indication exists, the recoverable amount of the assets is estimated and where relevant, an impairment loss is recognized to reduce the asset to its recoverable amount. Such impairment losses are recognized in the profit and loss account.

The gain or loss on disposal of a fixed asset is the difference between the net sales proceeds and the carrying amount of the relevant assets, and is recognized in the profit and loss account.

e. Foreign currencies

The books and records are maintained in Hong Kong dollars. Transactions in other currencies during the year are translated into Hong Kong dollars at exchange rates prevailing in effect at the time of the transactions. Monetary assets and liabilities denominated in other currencies at the balance sheet date are translated into Hong Kong dollars at rates of exchange in effect at the balance sheet date. Exchange differences are dealt with in the profit and loss account.

f. Deferred taxation

Deferred taxation is recognized in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the accounts. Taxation rates enacted or substantively enacted by the balance sheet date are used to determine deferred taxation.

Deferred tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Deferred tax liabilities are recognized on temporary differences arising on investments in subsidiaries, except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not be reversed in the foreseeable future.

In the prior year, deferred taxation was accounted for at the current taxation rate in respect of timing differences between profit as computed for taxation purposes and profit as stated in the accounts to the extent that a liability or an asset was expected to be payable or recoverable in the foreseeable future. The adoption of the new SSAP 12 represents a change in accounting policy, which has been applied retrospectively so that the comparatives presented have been restated to conform to the changed policy.

As detailed in Note 28 to the accounts, opening retained earnings at 1 January 2002 and 2003 have been increased by HK$5,423,000 and HK$8,961,000 respectively, which represent the unrecognized net deferred tax assets. This change has resulted in an increase in deferred tax assets as at 31 December 2001 and 31 December 2002 by HK$5,423,000 and HK$8,961,000 respectively. The profit for the year ended 31 December 2002 has been increased by HK$3,538,000.

g. Operating leases

Leases where substantially all the rewards and risks of ownership remain with the leasing Company are accounted for as operating leases. Rental payments under operating leases are charged to the profit and loss account on a straight-line basis over the period of the relevant leases. Lease income from operating sub-leases is recognized on a straight-line basis over the lease term.

h. Bad and doubtful loans

Provisions for bad and doubtful loans are charged to the profit and loss account on a monthly basis in accordance with the guidelines approved by the Board of Directors. General provision relates to exposures not separately identified but known from experience to exist in the mortgage portfolio. Specific provision for bad and doubtful loans generally applies to a mortgage loan that is overdue for more than 90 days and the current market value of the underlying property is less than the outstanding principal balance (OPB) of the mortgage loan. When there is no longer any realistic prospect of recovery of the OPB of the mortgage loan, it will be written off at the discretion of the Credit Committee.

The accrual of interest on mortgage loans is discontinued when they become overdue for 90 days or more. Any previously accrued and uncollected interests on the loans are reversed against current period's interest income. Interest income on the overdue loans is only recognized when all arrears of principal and interest from the borrowers have been cleared and it is probable that the customer is capable of fully servicing his obligations under the terms of the loans for the foreseeable future.

i. Repossessed assets

Assets acquired by repossession of collateral for realization are reclassified from "Mortgage portfolio, net" to "Other receivables, net" which are written down to forced sale value of the repossessed properties by setting off related specific provisions against the OPB of the mortgage loans.

j. Investment in debt securities

Held-to-maturity investments are investments which the Group has the expressed intention and ability to hold to maturity. They are carried at amortized cost less any provision for impairment in value.

The carrying amounts of held-to-maturity securities are reviewed at each balance sheet date to assess the credit risk and whether the carrying amounts are expected to be recovered. Provisions are made when the carrying amounts are not expected to be recovered and are recognized as an expense in the profit and loss account.

Provision against the carrying value of held-to-maturity securities are reversed to the profit and loss account when the circumstances and events that led to the write-downs or write-offs cease to exist and there is persuasive evidence that the new circumstances and events will persist in the foreseeable future.

Upon disposal or transfer of held-to-maturity securities, any profit and loss thereon is accounted for in the profit and loss account.

k. Notes issuance

The notes issued under the NIP, the notes and Transferable Loan Certificates (TLC) issued under the DIP and the notes offered to retail investors through the placing banks are stated at par value under debt securities in the balance sheet. Interest on the notes is accrued on a daily basis and charged to the profit and loss account. Discount on the notes is regarded as deferred expense whereas premium is accounted for as deferred income. Discount and premium are amortized over the entire life of the notes on an effective interest rate method and are accounted for as adjustment to the interest expense of the notes. The arranger and custodian fees paid under the NIP and DIP are amortized to the profit and loss account over the life of the notes issued.

On redemption/repurchase of the notes, the resulting gains or losses, being the difference between the redemption/repurchase amount and the carrying amount, are recognized in the profit and loss account in the year in which the redemption/repurchase takes place.

l. Interest rate swap (IRS) contracts for hedging purposes

The IRS contracts are solely entered into as a hedge against interest rate risk on the assets and liabilities.

The net interest payable or receivable arising from the IRS contracts is recorded on an accrual basis and charged against interest income or interest expenses of the underlying assets and liabilities.

Gains and losses on early termination of the IRS contracts are immediately recognized in the profit and loss account when the underlying assets or liabilities are early disposed of or redeemed.

Gains and losses on early termination of the IRS contracts originally accounted for as a hedge to an asset or a liability are amortized over the remaining original life of the IRS contracts when the underlying asset and liability is not early disposed of or redeemed.

m. Mortgage guarantee business

The mortgage guarantee business of the Company is accounted for on the annual accounting basis. Under the annual accounting approach, the Company makes provisions based on credible estimates of future income and outgoings to determine the underwriting result for the current accounting period. The underwriting result includes any adjustments arising from the correction of the previous estimates.

Gross premiums represent direct business written through the Authorized Institutions during an accounting period. The gross premiums include the reinsurance premiums to be paid to the approved reinsurers for reinsurance cover. The net premiums received by the Company comprise the risk premiums and servicing fees earned by the Company. The net premiums are recognized as income on a time-apportioned basis when the insurance coverage has been effective.

Unearned premiums represent that portion of net premiums written which are estimated to relate to risks and services subsequent to the balance sheet date.

Provisions are made for outstanding claims, claims incurred but not reported and loss reserve at the end of each year. For risk sharing business, 50% of the net risk premiums earned is set aside as a Contingency Reserve for a reasonable period of time in accordance with relevant regulatory guidelines and considered by Directors as appropriate.

n. Guaranteed mortgage-backed pass-through securitization

Upon completion of the sale of a mortgage pool to a third party Special Purpose Company (SPC) under the Guaranteed Mortgage-Backed Pass-Through Securitization Programme (MBS Pass-Through Programme) and the US$3 billion Mortgage-Backed Securitization Programme (Bauhinia MBS Programme), the Company derecognizes the applicable mortgage pool from its balance sheet; recognizes all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash and contingent liability in respect of the guarantee on timely payment of principal and interest on the MBS; and recognizes in the profit and loss account any gain or loss on the sale.

Where the Company guarantees the collectibility of the mortgage pool, it recognizes a monthly guarantee fee income from the SPC in the profit and loss account on a time-apportioned basis. Since the Company assumes all credit risks arising from the mortgage loans under the MBS Pass-Through Programme and the Bauhinia MBS Programme, it adheres to the loan provisioning guidelines in Note 2(h) approved by the Board of Directors for making necessary provisions in the profit and loss account.

o. Employee benefits

(i) Employee leave entitlements

Employee entitlements to annual leave and long-service leave are recognized when they accrue to employees. An accrual is made for the estimated liability for annual leave and long-service leave as a result of services rendered by employees up to the balance sheet date.

Employee entitlements to sick leave, maternity or paternity leave are recognized when the absence occurs.

(ii) Bonus plans

Liabilities for bonus plans due wholly within twelve months after the balance sheet date are recognized when the Company has a present or constructive obligation as a result of services rendered by employees and a reliable estimate of the obligation can be made.

(iii) Pension obligations

The Company offers a mandatory provident fund scheme and a defined contribution scheme, the assets of which are generally held in separate trustee – administered funds. These pension plans are generally funded by payments from employees and by the Company.

The Company's contributions to the mandatory provident fund scheme and defined contribution scheme are expensed as incurred and are reduced by the portion of employer contributions being forfeited by those employees who leave the scheme prior to full vesting of the employer contributions.

p. Contingent liabilities and contingent assets

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. It can also be a present obligation arising from past events that is not recognized because it is not probable that an outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognized but is disclosed in the notes to the accounts. When a change in the probability of an outflow occurs so that outflow is probable, it will then be recognized as a provision.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the Group.

Contingent assets are not recognized but are disclosed in the notes to the accounts when an inflow of economic benefits is probable. When inflow is virtually certain, an asset is recognized.

q. Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition including cash, balances with banks and other financial institutions, treasury bills, other eligible bills and certificates of deposit.

3. INTEREST INCOME

	The Group	
	2003	2002
	HK$'000	HK$'000
Mortgage portfolio	**826,459**	771,720
Cash and short-term funds	**33,851**	39,939
Investment in debt securities – listed	**51,982**	22,838
Investment in debt securities – unlisted	**94,554**	73,998
	1,006,846	908,495

4. INTEREST EXPENSE

	The Group	
	2003	2002
	HK$'000	HK$'000
Bank loans and debt securities wholly repayable within 5 years	**375,121**	474,842
Debt securities not wholly repayable within 5 years	**10,306**	2,697
	385,427	477,539

5. OTHER INCOME, NET

	The Group	
	2003	2002
	HK$'000	HK$'000
Early prepayment fees and late charges	**2,499**	3,497
Subletting income of office premises	**230**	2,760
Net insurance premiums earned *(Note 10)*	**38,277**	32,931
Guarantee fee income on MBS	**10,635**	7,676
Excess servicing receipts on MBS	**20,352**	6,122
Issuance costs of debt securities and MBS	**(4,477)**	(3,604)
Others	**(7,551)**	8,535
	59,965	57,917

6. OPERATING EXPENSES

	The Group	
	2003	2002
	HK$'000	HK$'000
Staff costs		
Salaries and benefits	**64,584**	61,493
Pension costs – defined contribution scheme	**3,501**	2,867
Premises		
Rental	**11,008**	11,001
Others	**6,535**	3,348
Directors' emoluments	**–**	–
Depreciation	**14,895**	14,534
Consultancy fees	**4,142**	7,227
Auditors' remuneration	**311**	230
Other operating expenses	**15,328**	12,630
	120,304	113,330

7. PROVISIONS FOR BAD AND DOUBTFUL LOANS

	The Group	
	2003	2002
	HK$'000	HK$'000
Provisions against mortgage portfolio		
– specific	**131,164**	63,945
– general	**18,206**	22,109
	149,370	86,054

8. NET GAIN ON DISPOSAL OF INVESTMENT IN DEBT SECURITIES

	The Group	
	2003	2002
	HK$'000	HK$'000
Net gain on disposal of investment in debt securities	**11,348**	2,580

During the year, investment in debt securities classified as held-to-maturity amounting to HK$364,754,000 (2002: HK$300,000,000) was sold due to the deterioration in the credit ratings of the issuer.

9. TAXATION

(a) Taxation charge in the profit and loss account represents:

	The Group	
	2003	2002
	HK$'000	HK$'000
		Restated
Hong Kong profits tax		
Provision for the year	**49,637**	29,448
Overprovision in respect of prior years	**(833)**	(849)
	48,804	28,599
Deferred taxation	**(4,882)**	(3,877)
	43,922	24,722

Hong Kong profits tax has been provided at the rate of 17.5% (2002: 16%) on the estimated assessable profit for the year. In 2003, the Government enacted a change in the profits tax rate from 16% to 17.5% for the fiscal year 2003/2004. Deferred taxation is calculated in full on temporary differences under the liability method using a principal taxation rate of 17.5% (2002: 16%).

The taxation on the Group's profit before taxation differs from the theoretical amount that would arise using the taxation rate of Hong Kong as follows:

	The Group	
	2003	2002
	HK$'000	HK$'000
Profit before taxation	**423,058**	292,069
Calculated at a taxation rate of 17.5% (2002: 16%)	**74,035**	46,731
Income not subject to taxation	**(29,036)**	(21,372)
Expenses not deductible for taxation purposes	**170**	212
Increase in opening net deferred tax assets resulting from an increase in tax rates	**(414)**	–
Overprovision in prior years	**(833)**	(849)
Taxation charge	**43,922**	24,722

(b) Provisions for taxation in the balance sheet represents:

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Hong Kong profits tax	**17,778**	18,608
Deferred tax assets	**(9,300)**	(4,418)
	8,478	14,190

There is no significant unprovided deferred taxation as at and for the year ended 31 December 2003. The major components of deferred tax assets and liabilities recorded in the consolidated balance sheet, and the movements in 2003 showing the impact of the adoption of SSAP 12, are as follows:

	The Group and the Company		
	Accelerated tax depreciation HK$'000	**Provisions HK$'000**	**Total HK$'000**
As at 1 January 2003, as previously reported	**4,543**	**–**	**4,543**
Effect of adoption of SSAP 12	**–**	**(8,961)**	**(8,961)**
As at 1 January 2003, as restated	**4,543**	**(8,961)**	**(4,418)**
Credited to profit and loss account	**(856)**	**(4,026)**	**(4,882)**
As at 31 December 2003	**3,687**	**(12,987)**	**(9,300)**

	The Group and the Company		
	Accelerated tax depreciation HK$'000	Provisions HK$'000	Total HK$'000
As at 1 January 2002, as previously reported	4,882	–	4,882
Effect of adoption of SSAP 12	–	(5,423)	(5,423)
As at 1 January 2002, as restated	4,882	(5,423)	(541)
Credited to profit and loss account	(339)	(3,538)	(3,877)
As at 31 December 2002	4,543	(8,961)	(4,418)

The amounts shown in the balance sheet include deferred tax assets of HK$12,987,000 (2002: HK$8,961,000) to be recovered after more than twelve months.

10. REVENUE ACCOUNT FOR MORTGAGE GUARANTEE BUSINESS

	The Group	
	2003	2002
	HK$'000	HK$'000
Gross premiums written	**194,339**	158,025
Reinsurance premiums	**(127,225)**	(104,041)
Net premiums written	**67,114**	53,984
Add: unearned premiums brought forward	**79,444**	60,301
unearned premiums carried forward	**(106,043)**	(79,444)
Increase in unearned premiums	**(26,599)**	(19,143)
Net premiums earned before provision	**40,515**	34,841
Provisions for outstanding claims and loss reserve *(Note 24)*	**(2,238)**	(1,910)
Net premiums earned *(Note 5)*	**38,277**	32,931
Management expenses	**(3,494)**	(3,287)
Underwriting gains	**34,783**	29,644

The management expenses formed part of the operating expenses in Note 6.

11. NET PROFIT FOR THE YEAR

The net profit for the year is dealt with in the accounts of the Company to the extent of HK$379,157,000 (2002: HK$267,377,000 as restated).

12. CASH AND SHORT-TERM FUNDS

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Cash at banks	**2,351**	1,042
Time deposits with banks	**2,216,995**	211,821
	2,219,346	212,863

13. INTEREST AND REMITTANCE RECEIVABLES

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Interest receivable from mortgage portfolio	**44,391**	50,753
Interest receivable from interest rate swap contracts	**254,024**	200,741
Interest receivable from investment in debt securities	**44,607**	36,559
Interest receivable from time deposits with banks	**102**	63
Loan instalments, in transit	**(45,282)**	22,435
	297,842	310,551

14. PREPAYMENTS, DEPOSITS, AND OTHER ASSETS

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Office rental deposit	**2,293**	2,293
Corporate club debentures	**670**	670
Other receivables, net	**159,732**	78,245
Others	**48,113**	29,547
	210,808	110,755

The Group reclassified mortgage loans from “Mortgage portfolio, net” (Note 16(a)) to “Other receivables, net” when the mortgage loans were overdue for 180 days or more, or the collateral properties were repossessed, or the mortgagors became bankrupt. The net amount represented the forced sale value of the collateral properties after setting off specific provisions of HK$107,707,000 (2002: HK$53,022,000) and general provisions of HK$236,000 (2002: HK$59,000) against the outstanding principal balance of the mortgage loans of HK$267,675,000 (2002: HK$131,326,000).

As at 31 December 2003, the forced sale value of the repossessed properties under “Other receivables, net” amounted to HK$54,079,000 (2002: HK$32,067,000).

15. DEFERRED EXPENSE, NET

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Deferred expenses/(income) arising on issuance of debt securities		
At 1 January	**21,876**	38,273
Additions for the year		
– deferred expenses	**16,000**	40,273
– deferred income	**(305)**	(18,956)
Less: amortization	**(10,925)**	(37,714)
At 31 December	**26,646**	21,876

16. MORTGAGE PORTFOLIO, NET

(a) Mortgage portfolio less provisions

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Outstanding principal balance of mortgage portfolio *(Note 20)*	**34,664,075**	28,318,693
Provisions for bad and doubtful loans		
– specific	**(13,863)**	(9,335)
– general	**(68,465)**	(51,631)
	34,581,747	28,257,727

At 31 December 2003, the mortgage portfolio had a weighted average remaining term of 11 years on a contractual basis, without taking into account any prepayment of the mortgage loans. Final maturity of the mortgage portfolio is in the year 2038.

(b) Provisions for bad and doubtful loans

	The Group and the Company			
				Suspended
	Specific	**General**	**Total**	**Interest**
	HK$'000	**HK$'000**	**HK$'000**	**HK$'000**
At 1 January 2003	**9,335**	**55,944**	**65,279**	**3,563**
Amounts written off	**(125,179)**	**(177)**	**(125,356)**	**(6,792)**
Charge to profit & loss account	**131,164**	**18,206**	**149,370**	**–**
Interest suspended during the year	**–**	**–**	**–**	**8,191**
Suspended interest recovered	**–**	**–**	**–**	**(1,363)**
At 31 December 2003	**15,320**	**73,973**	**89,293**	**3,599**

	The Group and the Company			
				Suspended
	Specific	General	Total	Interest
	HK$'000	HK$'000	HK$'000	HK$'000
At 1 January 2002	2,002	33,894	35,896	4,214
Amounts written off	(56,612)	(59)	(56,671)	(4,500)
Charge to profit & loss account	63,945	22,109	86,054	–
Interest suspended during the year	–	–	–	4,841
Suspended interest recovered	–	–	–	(992)
At 31 December 2002	9,335	55,944	65,279	3,563

As regards the loan provisioning on the guaranteed mortgage loans under the two MBS programmes, a sum of HK$1,457,000 specific provision (2002: Nil) and HK$5,508,000 general provision (2002: HK$4,313,000) was grouped under "Other provisions" (Note 22).

(c) The total mortgage loans on which interest has been placed in suspense or has ceased to accrue are as follows:

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Gross mortgage loans	**149,480**	88,644
Specific provisions	**(11,619)**	(8,668)
	137,861	79,976

Specific provisions were made after taking into account the current market value of the collateral of the delinquent loans.

17. INVESTMENT IN DEBT SECURITIES

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Investment in debt securities		
Listed in Hong Kong	**76,835**	–
Listed outside Hong Kong	**1,047,297**	1,047,040
Unlisted	**2,411,393**	2,197,480
	3,535,525	3,244,520
Market value of listed securities	**1,147,555**	1,104,215

The investment in debt securities included above are issued by:

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Banks and other financial institutions	**2,324,688**	2,362,022
Corporate entities	**1,196,296**	850,949
Others	**14,541**	31,549
	3,535,525	3,244,520

18. FIXED ASSETS

	The Group and the Company					
	Leasehold improvements HK$'000	Furniture and fixtures HK$'000	Computers and related software HK$'000	Office equipment HK$'000	Motor vehicle HK$'000	Total HK$'000
Cost						
As at 1 January 2003	11,415	1,783	70,115	2,471	539	86,323
Additions	13	–	5,617	30	–	5,660
Disposal/write-offs	–	–	(767)	–	–	(767)
As at 31 December 2003	**11,428**	**1,783**	**74,965**	**2,501**	**539**	**91,216**
Accumulated depreciation						
As at 1 January 2003	8,383	1,346	45,831	1,901	539	58,000
Charge for the year	1,521	219	12,886	269	–	14,895
Disposal/write-offs	–	–	(767)	–	–	(767)
As at 31 December 2003	**9,904**	**1,565**	**57,950**	**2,170**	**539**	**72,128**
Net book value						
Ending balance as at 31 December 2003	**1,524**	**218**	**17,015**	**331**	**–**	**19,088**
Ending balance as at 31 December 2002	3,032	437	24,284	570	–	28,323

19. INVESTMENT IN A SUBSIDIARY

	The Company	
	2003	2002
	HK$'000	HK$'000
Unlisted shares, at cost	**1,000**	1,000
Due to a subsidiary	**(967)**	(970)
	33	30

The amount due to a subsidiary is unsecured, interest free and has no fixed term of repayment.

The details of the subsidiary at 31 December 2003 are:

Name	Place of Incorporation	Principal activities	Nominal value of issued capital	Class of shares held	% of ordinary shares directly held
HKMC Mortgage Management Limited	Hong Kong	Mortgage purchases	HK$1,000,000 of HK$1 each	Ordinary	100%

20. MATURITY PROFILE

	The Group and the Company 2003						
	Repayable on demand HK$'000	3 months or less HK$'000	1 year or less but over 3 months HK$'000	5 years or less but over 1 year HK$'000	After 5 years HK$'000	Undated HK$'000	Total HK$'000
Assets							
– Cash and short-term funds	2,219,346	–	–	–	–	–	2,219,346
– Mortgage portfolio	16,998	1,013,684	2,614,389	12,649,959	18,361,232	7,813	34,664,075
– Investment in debt securities	–	269,000	850,000	1,650,718	765,807	–	3,535,525
	2,236,344	1,282,684	3,464,389	14,300,677	19,127,039	7,813	40,418,946
Liabilities							
– Debt securities	–	3,855,400	5,678,650	24,634,640	2,461,600	–	36,630,290

	The Group and the Company						
	2002						
	Repayable on demand HK$'000	3 months or less HK$'000	1 year or less but over 3 months HK$'000	5 years or less but over 1 year HK$'000	After 5 years HK$'000	Undated HK$'000	Total HK$'000
Assets							
– Cash and short-term funds	212,863	–	–	–	–	–	212,863
– Mortgage portfolio	13,509	707,390	1,607,070	9,071,777	16,912,400	6,547	28,318,693
– Investment in debt securities	–	454,235	386,359	1,926,145	477,781	–	3,244,520
	226,372	1,161,625	1,993,429	10,997,922	17,390,181	6,547	31,776,076
Liabilities							
– Debt securities	–	130,000	3,127,550	25,257,450	100,000	–	28,615,000

21. INTEREST PAYABLE

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Debt securities	**257,663**	223,122

22. ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER LIABILITIES

	The Group	
	2003	2002
	HK$'000	HK$'000
Accounts payable and accrued expenses	**376,320**	127,015
Other provisions *(Note 29)*	**14,292**	9,064
	390,612	136,079

	The Company	
	2003	2002
	HK$'000	HK$'000
Accounts payable and accrued expenses	**376,320**	127,015
Other provisions *(Note 29)*	**14,274**	9,064
	390,594	136,079

23. DEBT SECURITIES

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
NIP notes	**4,000,000**	5,000,000
DIP		
(i) notes	**22,441,000**	17,491,000
(ii) TLC	**3,500,000**	–
Other notes	**6,689,290**	6,124,000
	36,630,290	28,615,000
At 1 January	**28,615,000**	20,058,550
Issuance for the year	**10,885,540**	14,956,450
Less: Redemption for the year	**(2,870,250)**	(6,400,000)
At the end of the year	**36,630,290**	28,615,000

Notes and TLC issued during the year comprise:

	The Group and the Company			
	NIP notes	DIP notes	DIP TLC	Other notes
	HK$'000	HK$'000	HK$'000	HK$'000
Amount issued	–	6,050,000	3,500,000	1,335,540
Consideration received	–	6,049,980	3,500,000	1,319,865

All the debt securities issued are unsecured obligations of the Group, and are issued for the purposes of providing general working capital and refinancing.

24. PROVISIONS FOR MORTGAGE GUARANTEE BUSINESS

Provisions for outstanding claims under the MIP are recorded net of recoveries from the approved reinsurers. For the year ended 31 December 2003, provisions for loss reserve of HK$888,000 (2002: HK$403,000) for risk sharing business was charged to profit and loss account of the Group and the gross claim was HK$8,176,000 (2002: HK$9,295,000), of which HK$6,826,000 (2002: HK$7,788,000) was recovered from the approved reinsurers.

25. SHARE CAPITAL

	2003 & 2002
	HK$'000
Authorized	
3 billion ordinary shares of HK$1 each	3,000,000
Issued and fully paid	
2 billion ordinary shares of HK$1 each	2,000,000

26. NOTE TO THE CONSOLIDATED CASH FLOW STATEMENT

Reconciliation of profit before taxation to net cash outflow from operating activities:

	The Group	
	2003	2002
	HK$'000	HK$'000
Profit before taxation	**423,058**	292,069
Depreciation	**14,895**	14,534
Amortization of deferred expenses	**10,925**	37,714
Provisions for bad and doubtful loans	**149,370**	86,054
Mortgage portfolio written off net of recoveries	**(125,356)**	(56,671)
Amortization of investment in debt securities	**5,319**	3,835
Net gain on disposal of investment in debt securities	**(11,348)**	(2,580)
Operating cash inflow before changes in operating assets and liabilities	**466,863**	374,955
Decrease in interest and remittance receivables	**12,709**	26,625
Increase in prepayments, deposits and other assets	**(100,053)**	(74,429)
Increase in mortgage portfolio	**(6,345,382)**	(8,506,240)
Increase in interest payable	**34,541**	28,906
Increase in accounts payable, accrued expenses and other liabilities	**251,881**	72,338
Increase in unearned premiums	**26,599**	19,143
Exchange differences	**5,081**	–
Net cash outflow from operating activities before taxation	**(5,647,761)**	(8,058,702)
Hong Kong profits tax paid	**(60,935)**	–
Hong Kong profits tax refunded	**11,301**	–
Net cash outflow from operating activities	**(5,697,395)**	(8,058,702)

27. RELATED PARTY TRANSACTIONS

The Company entered into various transactions with the following related parties on a commercial basis.

Mr. Norman Chan is the Deputy Chief Executive of the Hong Kong Monetary Authority. The Company is a member under the Central Moneymarkets Unit (the “CMU”) Membership Agreement with the Monetary Authority through the CMU in respect of the Company’s HK dollar debt issuance and securities investment.

Mr. Brian Yiu is the Head of Debt Capital Markets, Asian Fixed Income of Standard Chartered Bank, which is (a) a selling group member under the DIP; (b) an Approved Seller/Servicer under the MPP; (c) an approved Authorized Institution under the MIP; and (d) an approved Authorized Institution under the HOME Programme.

Mr. Paul Thurston is the General Manager Personal Financial Services, Asia Pacific of HSBC. The Hon. Sin Chung-kai is an Assistant IT Project Manager of HSBC. HSBC is (a) a primary dealer under the DIP; (b) an Approved Seller/Servicer under the MPP; (c) an approved Authorized Institution under the MIP; (d) the underwriting bank and a placing bank in the Company’s retail note issuance in November 2003; (e) a dealer in the Company’s Bauhinia MBS Programme, and the lead manager and bookrunner of the Series 2003-1 issue of such programme; (f) an approved Authorized Institution under the HOME Programme; and (g) a holder of a TLC under the TLC Sub-Programme.

The Hon. Sin Chung-kai is also a member of The Hong Kong Housing Authority which is an Approved Seller/Servicer under the MPP from which the Company has purchased mortgage loans of around HK$20.6 billion up to 31 December 2003.

The Hon. Ambrose Lau is a Director of Nanyang Commercial Bank Limited and a Director of Wing Hang Bank, Limited. Wing Hang Bank, Limited is (a) an Approved Seller/Servicer under the MPP; (b) an approved Authorized Institution under the MIP; and (c) an approved Authorized Institution under the HOME Programme. Nanyang Commercial Bank Limited is (a) an Approved Seller/Servicer under the MPP; (b) an approved Authorized Institution under the MIP; (c) a placing bank in the Company’s retail note issuances in November 2003; and (d) an approved Authorized Institution under the HOME Programme.

Mr. Lam Yim-nam is the Deputy Chief Executive of Bank of China (Hong Kong) Limited, which during the time of Mr. Lam’s term of directorship with the Company, was (a) an Approved Seller/Servicer under the MPP; (b) an approved Authorized Institution under the MIP and (c) an approved Authorized Institution under the HOME Programme.

28. RESERVES

	The Group			
	Share capital	Contingency reserve	Retained profits	Total
	HK$'000	HK$'000	HK$'000	HK$'000
Balance at 1 January 2002, as previously reported	2,000,000	5,951	840,059	2,846,010
Effect of adopting SSAP 12	–	–	5,423	5,423
Balance at 1 January 2002, as restated	2,000,000	5,951	845,482	2,851,433
Net profit for the year, as restated	–	–	267,347	267,347
Transfer of 50% of net risk premium earned from retained profits to contingency reserve	–	10,026	(10,026)	–
Balance at 31 December 2002	2,000,000	15,977	1,102,803	3,118,780
Net profit for the year	–	–	379,136	379,136
Transfer of 50% of net risk premium earned from retained profits to contingency reserve	–	12,680	(12,680)	–
Balance at 31 December 2003	**2,000,000**	**28,657**	**1,469,259**	**3,497,916**

	The Company			
	Share capital HK$'000	Contingency reserve HK$'000	Retained profits HK$'000	Total HK$'000
Balance at 1 January 2002, as previously reported	2,000,000	5,951	840,059	2,846,010
Effect of adopting SSAP 12	–	–	5,423	5,423
Balance at 1 January 2002, as restated	2,000,000	5,951	845,482	2,851,433
Net profit for the year, as restated	–	–	267,377	267,377
Transfer of 50% of net risk premium earned from retained profits to contingency reserve	–	10,026	(10,026)	–
Balance at 31 December 2002	2,000,000	15,977	1,102,833	3,118,810
Net profit for the year	–	–	379,157	379,157
Transfer of 50% of net risk premium earned from retained profits to contingency reserve	–	12,680	(12,680)	–
Balance at 31 December 2003	**2,000,000**	**28,657**	**1,469,310**	**3,497,967**

29. EFFECTS ON THE CONSOLIDATED FINANCIAL STATEMENTS OF SPECIAL PURPOSE ENTITIES

In October 1999, the Company launched the MBS Pass-Through Programme under which the Company, in return for a guarantee fee, guarantees the timely payment of principal and interest in respect of the MBS issued by HKMC Funding Corporation (1) Limited, a special purpose company (SPC) incorporated in Hong Kong for the purpose of this programme.

In December 2001, the Company also launched the Bauhinia MBS Programme, under which Bauhinia MBS Limited, an SPC incorporated in the Cayman Islands for the purposes of this programme, will from time to time issue mortgage-backed securities. MBS will be issued by Bauhinia MBS Limited in different currencies under different tranches.

The above two SPCs are considered to be bankruptcy remote "orphan" companies. In the context of section 2(4) of the Hong Kong Companies Ordinance, the two SPCs are not construed as the Group's subsidiaries. In accordance with the provisions of paragraph 27 of SSAP 32 "Consolidated financial statements and accounting for investments in subsidiaries", the financial statements of these two SPCs have therefore not been consolidated into the Group's financial statements for the year ended 31 December 2003. With regard to the mortgage loans sold by the Company to the two SPCs, this would be effected by way of a "clean sale" of such mortgage loans to the SPCs. All the mortgage loans sold to the SPCs will no longer be recognized as an asset in the balance sheet of the Group.

Up to 31 December 2003, HKMC Funding Corporation (1) Limited had issued 8 series of MBS totalling HK$2,837 million and the Company had guaranteed the timely payment of principal and interest of the MBS. At 31 December 2003, the aggregate security principal balance of MBS guaranteed by the Company under the MBS Pass-Through Programme was HK$1,002.5 million. As regards the Company's loan provisioning on the guaranteed mortgage loans under the MBS Pass-Through Programme, a sum of HK$1,800,000 (2002: HK$1,498,000) was grouped under "Other provisions" (Note 22). The loan provision of HK$302,000 (2002: HK$171,000) was charged to the profit and loss account of the Group.

Up to 31 December 2003, Bauhinia MBS Limited issued 2 series of MBS totalling HK$5 billion and the Company had guaranteed the timely payment of principal and interest of the MBS. At 31 December 2003, the aggregate security principal balance of MBS guaranteed by the Company under the Bauhinia MBS Programme was HK$4,254 million. As regards the Company's loan provisioning on the guaranteed mortgage loans under the Bauhinia MBS Programme, a sum of HK$5,165,000 (2002: HK$2,815,000) was grouped under "Other provisions" (Note 22). The loan provision of HK$2,350,000 (2002: HK$2,815,000) was charged to the profit and loss account of the Group.

The operating profit after tax and the major assets and liabilities of HKMC Funding Corporation (1) Limited and Bauhinia MBS Limited are set out below:

	HKMC Funding Corporation (1) Limited HK$'000	Bauhinia MBS Limited HK$'000
For the year ended 31 December 2003		
Operating profit after tax	**23**	**24**
As at 31 December 2003		
Mortgage portfolio, net	**991,988**	**4,119,520**
Total Assets	**1,004,606**	**4,256,260**
Debt securities	**1,002,534**	**4,254,449**
Total Liabilities	**1,004,520**	**4,256,225**
Total shareholder's Equity	**86**	**35**

In accordance with paragraph 46 of SSAP 32, the Group has set out below the significant items of the pro-forma consolidated profit and loss account and balance sheet of the Group, HKMC Funding Corporation (1) Limited and Bauhinia MBS Limited for the year ended 31 December 2003 and 2002:

	2003 HK$'000	2002 HK$'000
Net interest income for the year	**652,955**	443,803
Net profit for the year	**379,183**	263,834
Mortgage portfolio, net	**39,686,290**	30,516,727
Cash and short-term funds	**2,224,181**	215,562
Interest and remittance receivables	**367,134**	336,995
Total Assets	**46,081,334**	34,474,398
Debt securities	**41,887,273**	30,931,520
Total Liabilities	**42,583,297**	31,364,504
Total Shareholder's Equity	**3,498,037**	3,109,894
Capital-to-Assets ratio	**7.3%**	8.5%

30. COMMITMENTS

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
(a) Capital		
Authorized and contracted for	**–**	–
Authorized but not contracted for	**25,185**	7,025
	25,185	7,025

(b) Operating lease

Total future minimum lease payments under non-cancellable operating leases at the balance sheet date are analyzed as follows:

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Office premises		
not later than one year	**11,001**	11,001
later than one year and not later than five years	**–**	11,001
	11,001	22,002

31. MORTGAGE GUARANTEE BUSINESS

The Company offers mortgage insurance which provides cover to the Approved Seller/Servicers for credit loss of up to 20% of the property value of a mortgage loan when the loan amount has exceeded 70% of the property value at origination.

The Company operates its mortgage insurance business on a risk-sharing basis, and retains up to 50% of the risk exposure under its mortgage insurance covers with the remaining risk exposure being ceded to its approved reinsurers.

Under the HOME programme, the Company provides mortgage insurance to cover credit loss in excess of 90% and up to 140% of the property value at the time of refinancing.

At 31 December 2003, the total risk-in-force was approximately HK$4.14 billion (2002: HK$3.39 billion) of which HK$3.05 billion (2002: HK$2.59 billion) risk for credit loss was ceded to the approved reinsurers and the balance of HK$1.09 billion (2002: HK$780 million) was assumed by the Company.

32. OFF-BALANCE-SHEET EXPOSURES

(a) Contingent liabilities

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Guarantees under MBS programmes	**5,256,983**	2,316,520

(b) Financial contracts

Interest rate swap contracts are entered into for hedging the interest rate risk of the assets and liabilities.

i) The outstanding contracted notional amount of the interest rate swap contracts is as follows:

	The Group and the Company	
	2003	2002
	HK$'000	HK$'000
Interest rate swap contracts	**77,749,150**	56,734,398

ii) The replacement costs and potential future credit exposure amounts of the interest rate swap contracts are as follows. These amounts do not take into account the effects of bilateral netting arrangements with the counterparties.

	The Group and the Company			
	2003		2002	
	Replacement cost	**Potential future credit exposure**	Replacement cost	Potential future credit exposure
	HK$'000	**HK$'000**	HK$'000	HK$'000
Interest rate swap contracts	**1,344,668**	**140,320**	1,401,061	123,970

The replacement costs represent the cost of replacing all interest rate swap contracts that have a positive value when marked to market. The potential future credit exposure amounts refer to the amount as computed in accordance with the Capital-to-Assets ratio guidelines (Note 33). The Group has not experienced any non-performance by its counterparties.

33. CAPITAL-TO-ASSETS RATIO

To ensure that the Company is managed in a prudent manner, the Financial Secretary of the Government of the Hong Kong Special Administrative Region approved the revised guidelines in 2003 in respect of the minimum Capital-to-Assets ratio ("CAR") to be maintained by the Company. The minimum CAR stipulated in the guidelines is still at 5%.

	2003	2002 Restated
Capital-to-Assets ratio	**7.7%**	9.0%

The Capital-to-Assets ratio is calculated as a ratio, expressed as a percentage, of the Company's total capital base to the sum of its total on-balance sheet assets and total off-balance sheet exposures.

34. COMPARATIVE FIGURES

Due to the adoption of SSAP 12 during the current year, the presentation of certain items and balances in the accounts have been revised to comply with the new requirements. Accordingly, certain comparative amounts have been reclassified to conform to the current year's presentation.

35. SUBSEQUENT EVENTS

On 15 January 2004, the Company purchased HK$9.8 billion of mortgage loans under the Home Starter Loan Scheme from the Government.

36. APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved by the Board of Directors on 1 April 2004.

Annex A

LIST OF APPROVED SELLER/SERVICERS AS AT END DECEMBER 2003

1. ABN AMRO Bank N.V.

2. AIG Finance (Hong Kong) Limited

3. American Express Bank Ltd.

4. Asia Commercial Bank Limited

5. Bank of America (Asia) Limited

6. Bank of China (Hong Kong) Limited

7. Bank of Communications

8. The Bank of East Asia, Limited

9.* Brilliant Oscar Limited

10. Canadian Eastern Finance Limited

11. Chekiang First Bank Limited

12. Chiyu Banking Corporation Limited

13. Citibank, N.A.

14. CITIC Ka Wah Bank Limited

15. Dah Sing Bank, Limited

16. DBS Bank (Hong Kong) Limited

17. Fortis Bank Asia HK
(also known as Wa Pei Fu Tong Yin Hang)

18. GE Capital (Hong Kong) Limited

19. The Government of the Hong Kong Special Administrative Region

20. Hang Seng Bank Limited

21. Hang Seng Credit Limited

22. Hang Seng Finance Limited

23. The Hong Kong Housing Authority

24. Hong Kong Housing Society

25. The Hongkong & Shanghai Banking Corporation Limited

26. Inchroy Credit Corporation Limited

27. Industrial and Commercial Bank of China (Asia) Limited

28. International Bank of Asia Limited

29. Liu Chong Hing Bank Limited

30. Nanyang Commercial Bank, Limited

31. ORIX Asia Limited

32.** ORIX Finance Services Hong Kong Limited

33. Pacific Finance (Hong Kong) Limited

34. Shanghai Commercial Bank Limited

35. Standard Chartered Bank

36. Wing Hang Bank, Limited

37. Wing Lung Bank, Limited

* Approved as Servicer only
** Approved as Seller only

Annex B

LIST OF MORTGAGE REINSURERS, DIP PRIMARY DEALERS, SELLING GROUP MEMBERS, PLACING BANKS FOR RETAIL BONDS AND PROGRAMME ARRANGER AND DEALER GROUP OF BAUHINIA MBS PROGRAMME

Mortgage Reinsurers
- Asia Insurance Company, Limited
- Hang Seng Insurance Company Limited
- HSBC Insurance (Asia) Limited
- PMI Mortgage Insurance Co.
- United Guaranty Mortgage Indemnity Company

DIP Primary Dealers
- Bank of China (Hong Kong) Limited
- DBS Bank (Hong Kong) Limited
- The Hongkong and Shanghai Banking Corporation Limited
- Merrill Lynch Far East Limited
- Mitsubishi Securities (HK) Limited
- UBS AG Hong Kong

DIP Selling Group Members
- ABN AMRO Bank N.V.
- The Bank of East Asia, Limited
- Barclays Bank PLC, Hong Kong Branch
- BNP Paribas
- BOCI Capital Limited
- Citicorp International Limited
- Commonwealth Bank of Australia
- Crédit Agricole Indosuez
- Credit Lyonnais, S.A., Hong Kong Branch
- Deutsche Bank AG, Hong Kong Branch
- Goldman Sachs (Asia) L.L.C.
- Hang Seng Bank Limited
- JP Morgan Securities (Asia Pacific) Limited
- Société Générale Asia Limited
- Standard Bank Asia Limited
- Standard Chartered Bank

Placing Banks for Retail Bonds
- Bank of China (Hong Kong) Limited
- Bank of Communications Hong Kong Branch
- The Bank of East Asia, Limited
- Chiyu Banking Corporation Limited
- Citibank, N.A., Hong Kong Branch
- CITIC Ka Wah Bank Limited
- DBS Bank (Hong Kong) Limited
- Hang Seng Bank Limited
- The Hongkong and Shanghai Banking Corporation Limited
- Industrial and Commercial Bank of China (Asia) Limited
- International Bank of Asia Limited
- Nanyang Commercial Bank, Limited
- Shanghai Commercial Bank Limited
- Standard Chartered Bank
- Wing Lung Bank Limited

Bauhinia MBS Programme

Programme Arranger
- Merrill Lynch International

Dealer Group
- Barclays Bank PLC, Hong Kong Branch
- DBS Bank (Hong Kong) Limited
- Deutsche Securities Limited
- The Hong Kong and Shanghai Banking Corporation Limited
- JP Morgan Securities (Asia Pacific) Limited
- Merrill Lynch International
- Salomon Brothers International Limited
- UBS Warburg

Annex C

KEY STATISTICS OF THE HKMC MORTGAGE PORTFOLIO (including Mortgage Loans with the HKMC's Guarantee)

	Jan-03	Feb-03	Mar-03	Apr-03
Aggregate				
Number of Approved Sellers/Servicers	37	37	37	37
Number of Active Sellers	26	26	26	26
Geographical Distribution				
Number of Loans	48,762	48,585	49,426	49,191
– Hong Kong	7,526	7,480	7,688	7,636
– Kowloon	8,998	8,954	9,226	9,200
– New Territories	32,238	32,151	32,512	32,355
Outstanding Principal Balance (HK$million)	29,941	29,599	30,142	29,782
– Hong Kong	5,804	5,718	5,869	5,779
– Kowloon	5,567	5,495	5,661	5,621
– New Territories	18,570	18,386	18,612	18,382
Delinquency (%)				
– > 90 days	0.34%	0.35%	0.42%	0.43%
Charge-off Ratio (%)	0.05%	0.07%	0.06%	0.06%
Monthly Prepayment (%)				
– Full	0.54%	0.55%	0.56%	0.62%
– Partial	0.11%	0.07%	0.10%	0.09%
Weighted Average##				
LTV Ratio at Origination (%)	66.0	66.0	65.8	65.7
Estimated Current LTV Ratio (%)	102.3	103.5	102.4	104.7
DTI at Origination (%)	40.0	40.0	39.7	39.7
Remaining Contractual Term to Maturity (months)	162	162	160	160
Seasoning (months)	59	59	59	59
Contractual Life (months)	221	221	219	219

KEY STATISTICS OF MORTGAGE INSURANCE PROGRAMME

	Jan-03	Feb-03	Mar-03	Apr-03
Number of Participating Banks	30	30	30	30
Accumulated Aggregate				
Applications Received				
Number of Applications	21,872	22,202	23,115	24,365
Total Amount of Mortgage Loans (HK$ million)	41,881	42,433	43,989	45,860
Total Risk in Force (HK$ million)	9,004	9,133	9,491	9,939
Average Size of Mortgage Loan (HK$ million)	1.9	1.9	1.9	1.9
LTV Ratio at Origination (%)				
– 80% or below	13	13	13	13
– above 80% and up to 85%	35	35	34	33
– above 85% and up to 90%	52	52	53	54
Applications Approved				
Number of Approved Applications	18,131	18,363	18,834	19,726
Total Amount of Mortgage Loans (HK$ million)	34,667	35,028	35,825	37,155
Total Risk in Force (HK$ million)	7,403	7,487	7,671	7,989
Type of Property Transaction				
Primary (%)	24	24	26	28
Secondary (%)	76	76	74	72
Choice of Premium Payment Method				
Single Payment (%)	94	94	94	94
Annual Payment (%)	6	6	6	6

Notes:
Figures exclude mortgage loans with co-financing arrangements.

May-03	Jun-03	Jul-03	Aug-03	Sep-03	Oct-03	Nov-03	Dec-03
37	38	38	38	38	38	38	38
26	26	26	26	26	26	26	26
60,165	60,182	60,454	66,316	65,860	65,286	65,862	79,755
10,788	10,714	10,770	11,537	11,402	11,189	11,211	12,868
11,907	11,846	11,923	13,060	12,977	12,882	13,026	15,352
37,470	37,622	37,761	41,719	41,481	41,215	41,625	51,535
34,069	33,710	33,703	35,508	34,954	34,407	34,203	39,354
7,113	6,989	6,973	7,173	7,026	6,873	6,773	7,359
6,756	6,652	6,673	7,050	6,937	6,834	6,804	7,650
20,200	20,070	20,057	21,284	20,991	20,700	20,626	24,345
0.39%	0.43%	0.40%	0.46%	0.45%	0.44%	0.31%	0.27%
0.16%	0.05%	0.08%	0.05%	0.07%	0.06%	0.20%	0.05%
0.55%	0.51%	0.73%	0.56%	0.62%	0.74%	0.66%	0.53%
0.11%	0.11%	0.13%	0.10%	0.08%	0.12%	0.15%	0.09%
65.8	65.8	65.7	65.7	65.8	65.8	65.8	65.9
106.7	107.7	106.1	105.9	104.7	102.2	98.1	95.1
39.7	39.7	39.2	39.3	39.3	39.3	39.3	39.3
159	158	159	158	158	157	157	156
60	61	60	61	62	63	63	64
219	219	219	219	220	220	220	220

May-03	Jun-03	Jul-03	Aug-03	Sep-03	Oct-03	Nov-03	Dec-03
30	30	28	28	28	28	28	28
25,200	26,179	27,459	28,184	28,992	30,326	31,082	31,876
47,175	48,651	50,575	51,685	53,028	55,387	56,736	58,100
10,254	10,604	11,059	11,319	11,634	12,182	12,493	12,812
1.9	1.9	1.8	1.8	1.8	1.8	1.8	1.8
13	13	13	12	12	12	12	12
32	31	30	30	30	29	28	28
55	56	57	58	58	59	60	60
20,278	20,830	21,570	22,317	22,811	23,720	24,417	24,995
38,008	38,842	39,916	41,040	41,807	43,388	44,619	45,559
8,191	8,389	8,645	8,905	9,085	9,455	9,736	9,966
28	29	31	31	31	32	33	33
72	71	69	69	69	68	67	67
94	94	94	95	95	95	95	95
6	6	6	5	5	5	5	5

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