Business Overview

Business Overview

Performance Highlights

The major achievements of the Corporation for the year included:

- Purchasing a total of HK$0.9 billion loan assets.
- Helping homebuyers borrow a total of HK$22 billion mortgage loans through the Mortgage Insurance Programme (MIP), representing a usage rate of 11.5% (in terms of the total drawdown amount under the MIP against the total market mortgage drawdown amount).
- Launching the Microfinance Scheme (MF Scheme) on 29 June 2012 to assist people who wish to start their own businesses, become self-employed or achieve self-enhancement through training, upgrading of skills or obtaining professional certification.
- Introducing the Special Concessionary Measures under the SME Financing Guarantee Scheme (SFGS) on 31 May 2012 as part of the package of support measures announced by the Financial Secretary in the 2012–2013 Budget Speech for SMEs to tide over the uncertain global economic environment and the possible financing difficulties as a result of credit crunch.
- Issuing HK$19.1 billion of debt securities in a cost-effective manner, maintaining the Corporation's position as the most active corporate issuer in the Hong Kong dollar debt market.
- Safeguarding excellent credit quality, with (over 90-day) delinquency ratios of 0.002% for the mortgage insurance portfolio, 2.41% for the SME guarantee portfolio (excluding the 80/20 product under SFGS), 0.04% for the Hong Kong residential mortgage portfolio (industry average of 0.02%), zero for microfinance loan portfolio and 0.03% across all asset classes as at 31 December 2012.
- Maintaining the HKMC's long-term foreign and local currency ratings of AAA and Aa1 by Standard & Poor's (S&P) and Moody's Investors Service, Inc. (Moody's) respectively.

The Corporation registered solid financial results for 2012:

- Profit attributable to shareholders of HK$1,125 million.
- Net interest spread of 1.4%.
- Return on assets of 1.9%.
- Return on shareholders' equity of 12.4%.
- Capital adequacy ratio of 20.2%, well above the minimum requirement of 8%.
- Cost-to-income ratio of 15.4%, significantly lower than the banking industry average of 45.6%.

Operational Highlights

Overall Business Strategy

Since its inception in 1997, the Corporation has been committed to its three core missions, namely (1) to enhance the stability of the banking system, (2) to promote home ownership, and (3) to develop the debt market in Hong Kong. In recent years, it has also launched a number of new programmes, such as the SFGS, the Reverse Mortgage Programme (RMP) and the MF Scheme to further strengthen its policy roles and to bridge the market gaps.

In 2012, the Corporation maintained its prudent commercial principles in executing its business strategy amid a very challenging external environment. To better meet the market needs, it introduced the Special Concessionary Measures under the SFGS with the Government's support, and three enhancements to the RMP, which have all received very encouraging market response. Also, at the request of the Financial Secretary, the Corporation launched the MF Scheme with a trial period of three years to provide not only capital loans but also ancillary entrepreneurial support to the borrowers.

With a view to better focusing on its increasingly diversified business in Hong Kong, the Corporation in 2012 began to move away from its two overseas joint ventures in Mainland China and Malaysia. As the Corporation has achieved its objective of fostering the transfer of knowledge and technology in the two markets over the past few years, it was considered an appropriate time for the Corporation to consolidate its resources to further develop its local business and fulfil its core missions.

Mortgage Insurance

In response to the prudential measures for residential mortgage loans initiated by the Hong Kong Monetary Authority in September 2012, the Corporation revised the eligibility criteria of the MIP. The revisions were intended to better manage the increased risk in high loan-to-value (LTV) mortgage lending under the current market conditions and to help homebuyers avoid overstretching themselves.

In 2012, the MIP drawdown loan amount was HK$22 billion, and the usage rate stood at 11.5%. The Corporation continued to provide training seminars for frontline staff of banks. This was an integral part of the strong partnership between the Corporation and banks in promoting mortgages to the public.

The Corporation maintained a high degree of processing efficiency for MIP applications through automation and the use of internet platforms. Most of the MIP applications were processed within two business days.

Funding activities

The Corporation issued HK$19.1 billion of corporate debt in different currencies, including Hong Kong dollars, US dollars, renminbi, Australian dollars, British pounds, Japanese yen and Singapore dollars, in a prudent and cost-effective manner to support asset-purchase activities and redemption of maturing debt. The Corporation was the most active corporate issuer in the Hong Kong dollar debt market, with issuance of HK$7.5 billion of debt securities in the local institutional market.

Market Overview

General Economic Conditions

Hong Kong recorded a modest growth in 2012 due to the subdued performance of the export sector as most western countries suffering from shrinking economy and high unemployment continued slashing their spending. The election in the US as well as leadership changes in Mainland China and Hong Kong, generated uncertainties which, to some extent, undermined major central banks' efforts in implementing stimulus measures.

Amid the challenging external trading environment, the Hong Kong economy decelerated notably to a scant growth of 0.8% year-on-year in real terms in the first quarter of 2012. Since the second half of the year, signs of moderate pick-up in economic growth turned more apparent in the wake of the stabilisation of the euro zone sovereign debt crisis. After several quarters of slowdown since 2010, Mainland China's economy saw a moderate rebound in the fourth quarter, leaving the full year growth at 7.8%. The rebound of Mainland China's economy helped boost the growth momentum in Hong Kong in the second half of the year.

The third round of quantitative easing (QE3) introduced by the US Federal Reserve in September provided impetus to the progressive economic growth. Amid the uncertainties in the market, Hong Kong's Gross Domestic Product grew slower at 1.4% year-on-year in real terms in 2012, compared with 4.9% growth in 2011.

Despite the strong external headwinds, the robust labour market and buoyant property market provided solid support to domestic consumption spending, which grew steadily throughout 2012. The unemployment rate stayed at a low level of around 3.2%–3.4%. On the back of more monetary easing measures announced by the major advanced economies and the tentative deal to avert the threat to the US economy from the "fiscal cliff", the local stock market rallied to end the year 23% higher than a year earlier.

Liquidity and Interest-Rate Environment

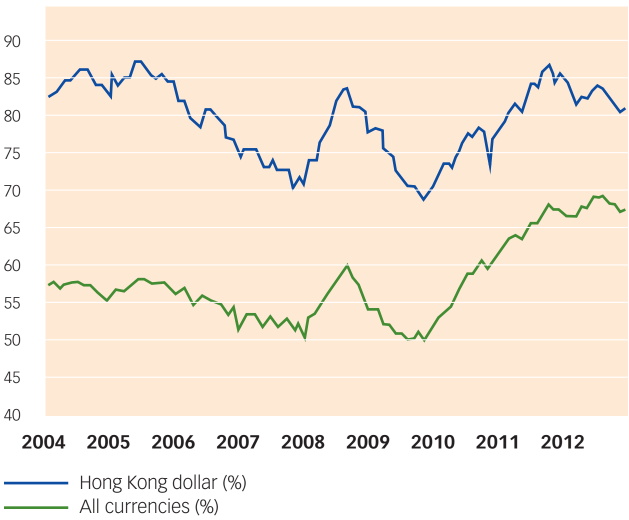
The liquidity condition in the banking sector eased further towards the end of the year on the back of the implementation of economic stimulus packages by many central banks.

In response to the slowdown in the global economy, central banks across major advanced economies such as Japan and Europe rolled out a string of stimulus measures in order to prevent the economies from falling into cyclical recession. In the US, the Federal Reserve introduced the QE3, and showed its intention to keep the interest rate near zero as long as the unemployment rate remains above 6.5% and the projected inflation is no more than 2.5%. The People's Bank of China also moved to loosen its tightening posture to guard against a hard landing.

The launch of such stimulus policies led to a massive influx of capital into Hong Kong, which pushed deposit rates and mortgage rates lower. The Hong Kong dollar has been hitting the upper limit of its peg to the US dollar at 7.75. Meanwhile, the easing liquidity condition in Mainland China lessened Mainland-related demand for offshore lending in Hong Kong. As a result, Hong Kong dollar deposits grew faster than Hong Kong dollar loans. The Hong Kong dollar loan-to-deposit ratio declined mildly in 2012 **(Figure 1)**.

Figure 1

Loan-to-Deposit Ratio

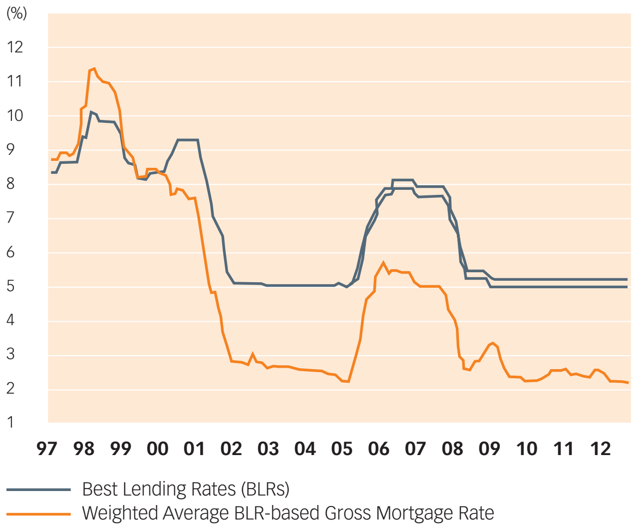


Source: HKMA

The low interest-rate environment in Hong Kong continued in 2012 amid the ongoing monetary easing policy in the US. While the Best Lending Rates (BLRs) remained stable at 5% and 5.25% throughout the year, the Hong Kong Interbank Offered Rates (HIBORs) declined progressively, with the one-month HIBOR falling from 0.36% in January to 0.28% in December, in terms of the period average[1]. As the banking system in Hong Kong overflowed with global liquidity, local banks resumed competition for mortgage lending business by progressively reducing mortgage rates. As a result, BLR-based mortgage rates slightly fell to the range of BLR-1.5% to BLR-3.1% towards the end of 2012 from BLR-1.5% to BLR-2.75% earlier in the year **(Figure 2)**.

Figure 2

Best Lending Rate and Gross Mortgage Rate



Source: HKMA, and HKMC estimates

Property Market

Amid the low interest-rate environment and acute demand-supply imbalance, the residential property market stayed buoyant throughout 2012 despite the global economic slowdown. Market sentiment received another boost after the US Federal Reserve announced another round of economic stimulus measures in September.

Fuelled by the ample funding available in the banking sector, residential property prices[2] at the end of 2012 surged by a cumulative 25% year-on-year and surpassed the 1997 peak by around 31% **(Figure 3)**. The price surge was even more rampant in small-sized flats as new stabilisation measures curtailed the demand for luxury flats. Small flats with saleable area less than 40 square metres showed the largest price appreciation, gaining 30% year-on-year while large flats with saleable area of 160 square metres or above rose 9%.

[1] Source: HKMA Monthly Statistical Bulletin

[2] Source: The Private Domestic Price Index published by the Rating and Valuation Department

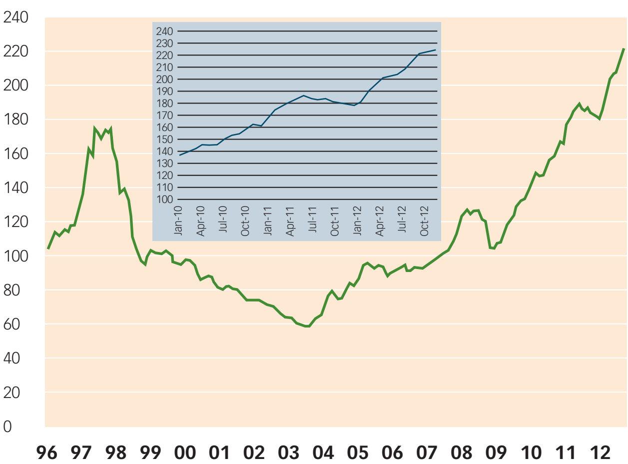
In response to the continuing rally in housing prices, the Government reiterated its concern and took steps to cool the market. To alleviate the risk of a property bubble, the Government announced in August and September measures aimed at increasing land supply and averting the excessive growth of mortgage loans. In October, the Government rolled out further measures to stabilise the housing market by introducing the enhanced Special Stamp Duty and the Buyer's Stamp Duty.

Earlier in the year, the slow global economic growth and the likelihood of Hong Kong's new Chief Executive introducing more cooling measures to stabilise the housing market dampened market sentiment, resulting in a sharp drop in residential transaction volume in the first half of 2012. Between January and June, the total property transactions fell 25% year on year, while the total value of transactions fell by 17%.

However, the market turned more active in the second half of the year as central banks in major advanced economies pledged to ease monetary conditions to stimulate economic growth. Despite that, the transaction volume fell visibly in December from the previous month due to the introduction of another round of property cooling measures. In general, the total number of property transactions in 2012 recorded a decline of 4% year-on-year but the aggregate transaction value rose by 2% **(Figure 4)**.

Figure 3

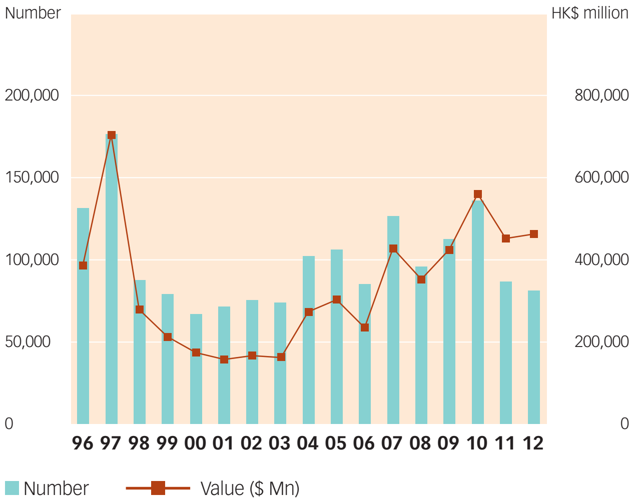
Private Domestic Price Index (1999 = 100)



Source: Rating and Valuation Department

Figure 4

Agreements of Sale and Purchase of Residential Building Units



Source: Land Registry

Mortgage Market

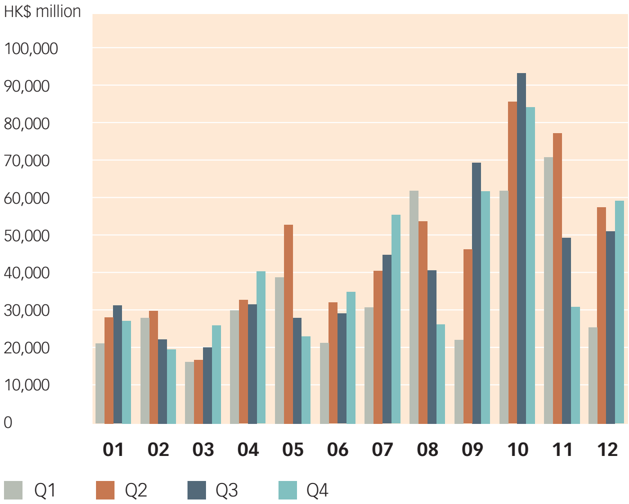
In September 2012, noting that QE3 would further heat up the local property market, the Hong Kong Monetary Authority (HKMA) issued further prudential supervisory measures to tighten the underwriting criteria for mortgages to borrowers with multiple property mortgages and introduce a ceiling on mortgage tenors.

In tandem with the reduction in residential property transactions, mortgage lending also declined in the first half of the year, with the gross value of new loans[3] dropping by 45% year-on-year. However, another round of monetary easing in the US in September eased market concern and the decline in new mortgage lending narrowed to 16% year-on-year **(Figure 5)** for the whole of 2012. Despite the contraction in new mortgage lending, the total outstanding value of all residential mortgage loans registered an annual increase of 7.6% to HK$914.5 billion in 2012.

[3] Source: HKMA's Monthly Residential Mortgage Survey ("The HKMA Survey")

Figure 5

New Residential Mortgage Loans Made

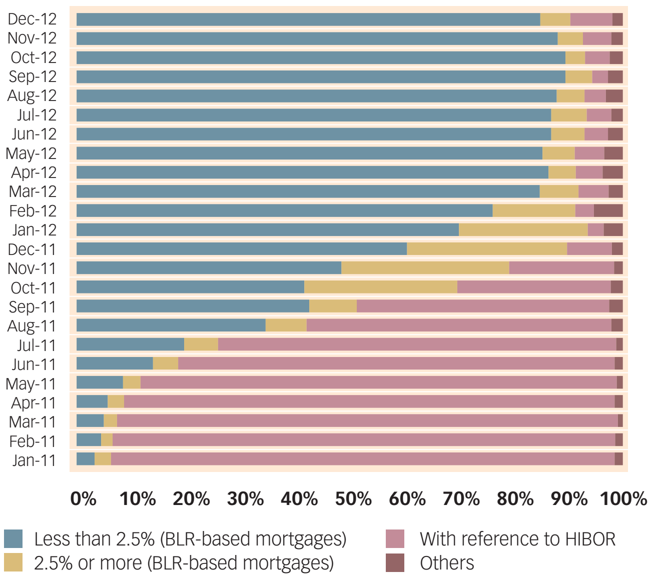


Source: HKMA

BLR-based mortgage plans remained the mainstream product in the mortgage market. The proportion of new mortgage loans priced with reference to the BLR rose to nearly 90.4% in December 2012, from 89.8% a year earlier, with the largest portion priced at a mortgage rate of 2% to 2.25%. The share of HIBOR-based mortgages declined to 7.7% from 8.2% during the same period **(Figure 6)**.

Figure 6

Pricing of New Residential Mortgage Loans Approved

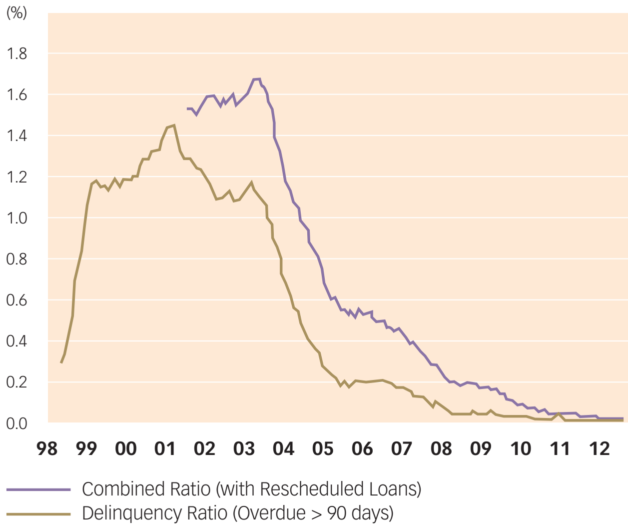


Source: HKMA

With the stable labour market and the HKMA's prudent supervision of the mortgage lending sector, the asset quality of residential mortgage loans remained excellent in 2012. The over-90-day delinquency ratio of mortgage loans[4] stayed at a historical low of 0.01% for most of the year, reflecting the prudent underwriting standards adopted by the banks. The combined ratio, which takes into account both delinquent and rescheduled loans, also remained low at between 0.02% and 0.03% for most of 2012 **(Figure 7)**. Given the continued surge in residential property prices, no mortgage loans in negative equity were reported at end-December.

Figure 7

Delinquency Ratio of Residential Mortgage Loans



Source: HKMA

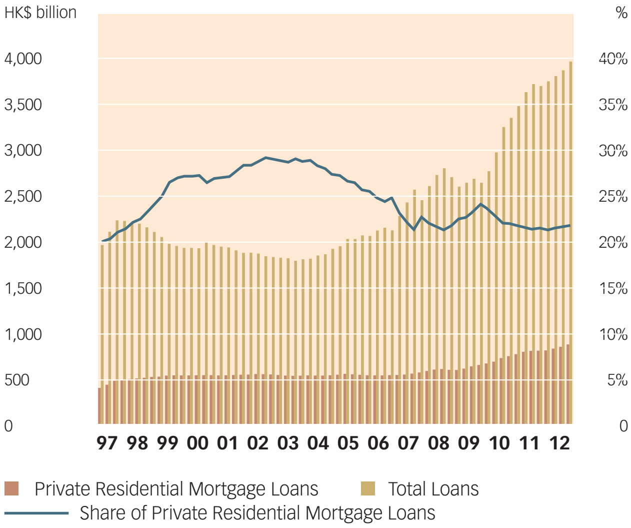
Banking-Sector Exposure

The total outstanding value of mortgage loans for private residential properties increased to HK$872.6 billion at the end of 2012 (end-2011: HK$805 billion), accounting for more than one-fifth of total loans in Hong Kong **(Figure 8)**. Adding to this the lending for building and construction, along with property development and investment, the amount of property-related loans totalled HK$1,802 billion, representing about half the total loan book of banks. The outstanding value of mortgage loans for the purchase of flats in Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme fell to HK$41.9 billion at the end of 2012 (end-2011: HK$45.6 billion).

[4] Source: The HKMA Survey

Figure 8

Total Loans and Private Residential Mortgage Loans of All Authorized Institutions



Source: HKMA

Asset Acquisition

The Corporation was actively engaged in discussions with many banks during the year. In view of the ample liquidity in the market and the improving capital adequacy of banks in 2012, banks faced less pressure to offload assets. During the year, the Corporation acquired HK$865 million of assets, which included residential mortgage loans and other assets.

Special Concessionary Measures offering 80% guarantee under the SME Financing Guarantee Scheme introduced

With the support of the Government, the Corporation introduced the time-limited Special Concessionary Measures under the SFGS on 31 May 2012. The Special Concessionary Measures, offering new 80% loan guarantee on eligible loans approved by Authorized Institutions in Hong Kong at a substantially lowered guarantee fee rate for an initial application period of nine months up to 28 February 2013, were part of the package of support measures announced by the Financial Secretary in the 2012–2013 Budget Speech for SMEs to tide over the uncertain global economic environment and the possible financing difficulties as a result of credit crunch. The Government provides a total guarantee commitment of HK$100 billion on the new guarantee products. The Corporation administers the new 80% loan guarantee products on prudent commercial principles.

The new 80% loan guarantee products have been well received by the market because they provide higher guarantee protection to encourage banks to lend to SMEs amidst uncertain global economic environment, and hence alleviate the adverse effects on SMEs. By the end of 2012, a total of 30 Authorized Institutions have joined the SFGS as participating lenders, and more than 5,000 applications for a total loan amount of approximately HK$23 billion were approved under the Special Concessionary Measures, benefiting over 3,700 local SMEs and more than 106,000 related employees.

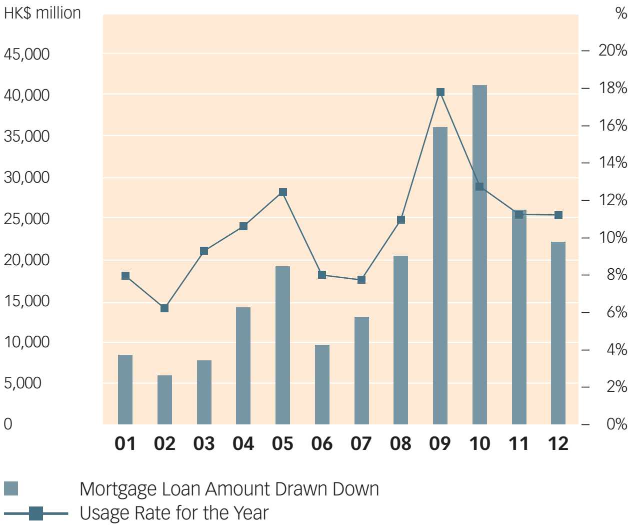
Mortgage Insurance

Over the years, the MIP has repeatedly demonstrated its effectiveness in helping potential homebuyers overcome the hurdle of meeting the substantial down payment required to purchase a property. From the perspective of the banking industry as a whole, the MIP allows banks to engage in higher LTV lending without incurring additional credit risks and affecting the overall stability of the entire banking system. All in all, the programme creates a win-win situation for both homebuyers and banks.

Since its inception in March 1999, the MIP has gained increasing public acceptance and has played a significant role in promoting home ownership in Hong Kong. In 2012, the volume of loans drawn down amounted to HK$22 billion and the usage rate (in terms of the total drawdown amount under the MIP against the total market drawdown amount) stood at 11.5% **(Figure 9)**. It is notable that 96% of the MIP applications received were for secondary market properties, demonstrating that mortgage insurance has been crucial in assisting homebuyers in the secondary market.

Figure 9

Mortgage Loan Amount Drawn Down and Usage Rate* of MIP



Sources: HKMA and HKMC

$$\text{* Usage Rate} = \frac{\text{Total drawdown amount under the MIP}}{\text{Total market drawdown amount based on HKMA's Monthly Residential Mortgage Survey}}$$

Since 1999, the MIP has helped over 103,000 families achieve the dream of home ownership, with aggregate loan drawdown of HK$232 billion.

MIP Revisions

In response to the prudential measures for property mortgage loans announced in September 2012 by the HKMA, the Corporation announced revisions to the MIP, including (i) for applicants who have already borrowed or guaranteed outstanding mortgage loans for two or more residential or non-residential properties at the application of MIP cover, the maximum debt-to-income (DTI) ratio is lowered to 40% from 50% (Note: The maximum DTI ratio is lowered to 35% from 45% for those applicants who are non-professional self-employed persons applying for mortgages with loan-to-value ratio above 85%); and (ii) the maximum term to maturity is shortened to 30 years from 40 years for all MIP applications. The purpose of the revisions of eligibility criteria was to better manage the increased risks of high LTV mortgage lending under current market conditions and to help homebuyers to avoid overstretching themselves.

Reverse Mortgage Programme

The RMP has received good market reception since its launch in around mid-2011 to provide elderly people with an additional financial planning option to enhance their quality of life. By the end of 2012, the Corporation had received over 4,000 public enquiries on reverse mortgage and had approved more than 310 applications, with an average property value of about HK$3.7 million. The average age of borrowers was 71 years old, while the average monthly payout amount was HK$13,400. To better meet the market demands, the Corporation introduced three enhancements to the RMP in November 2012, which included: (1) lowering the minimum age of borrowers from 60 to 55, (2) increasing the maximum specified property value for payout calculation from HK$8 million to HK$15 million, and (3) increasing the maximum lump-sum payout amount. All these enhancements offered greater flexibility and benefits to both existing and prospective borrowers.

Launch of Microfinance Scheme

To provide a platform for building social capital, the Financial Secretary commissioned the Corporation to introduce the MF Scheme. The Corporation launched the MF scheme in June 2012 in collaboration with six banks and five non-governmental organisations (NGOs). The MF Scheme will run for a trial period of three years with a tentative maximum loan amount of HK$100 million. The MF Scheme offers three categories of loans, namely Micro Business Start-up Loan, Self-employment Loan and Self-enhancement Loan. The target borrowers are business starters, self-employed persons and those wanting to achieve self-enhancement through training, upgrading of skills or securing professional certification. Apart from extending loans, the MF Scheme also provides mentoring services, entrepreneurial training and ancillary support to the borrowers to improve their business viability. So far, the MF Scheme has received encouraging response from the market. By the end of 2012, the MF Scheme had approved a total of 47 loans with a total loan amount of HK$12.75 million.

Education and Promotion Activities

To help banks better introduce the Corporation's products to their clients and to make the operation flow between banks and the Corporation smoother, different training courses are organised by the Corporation for the frontline bank staff from time to time. These can effectively help the frontline bank staff better understand the Corporation's programmes, and update them with any new developments.

The Corporation strives for raising the awareness of its new products among different relevant stakeholders. To this end, the Corporation continues to put great efforts in conducting educational and promotional campaigns through different channels, such as advertising, media interviews, and information leaflets. The Corporation also holds various types of education seminars and public talks in collaboration with educational institutions, professional bodies, governmental agencies and NGOs. In 2012, the Corporation gave 20 sharing sessions and public seminars on the MF Scheme, 22 on the RMP, and over 20 on the SFGS.

Joint Ventures Outside Hong Kong

The two overseas joint ventures including Cagamas HKMC Berhad (CHKMC) and Bauhinia HKMC Corporation Limited (BHKMC) had served their purpose to foster technology transfer and cooperation among regional central banks. In light of the need for the Corporation to focus on the local market, the Corporation intended to phase out its overseas joint ventures.

For the CHKMC, the Corporation completed the sale of its 50% stake in the CHKMC to the joint venture partner Cagamas at the end of 2012. For the BHKMC, the Corporation is working on the disposal arrangement with the joint venture partner.

Funding

The global financial markets continued to ride a bumpy path in 2012 under the menace of the lingering European debt crisis and sluggish US economic growth. In spite of the challenging market conditions, the Corporation managed to secure prudent pre-funding to cater for loan purchases and refinancing. Given the Corporation's strong background as a wholly government-owned entity and its solid credit rating, as well as investors' flight-to-quality inclination, the Corporation continued to be the most active Hong Kong dollar corporate bond issuer. In 2012, a total amount of HK$19.1 billion of debts were raised. At the end of 2012, the Corporation's total outstanding debt amounted to HK$36.4 billion.

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

The Corporation has three debt issuance programmes, which allow the issuance of debt securities in an efficient and effective manner. With its strong credit rating, the Corporation's debt issues are well received by the investment community, such as pension funds, insurance companies, investment funds, charities, government-related funds and retail investors. The Corporation maintains a proactive approach, updating investors regularly in local and regional markets.

Medium Term Note Programme

The Corporation established the multi-currency Medium Term Note (MTN) Programme in June 2007 to raise funds in the international market and broaden its investor base and funding sources. It was set up with an initial programme size of US$3 billion, which was subsequently increased to US$6 billion in July 2011 to meet growing demand from overseas investors. The multi-currency feature of the programme enables the Corporation to issue notes in major currencies, including Hong Kong dollars, US dollars, renminbi, euro and Japanese yen, to meet demand from both local and overseas investors. All foreign currency-denominated MTN debt is fully hedged into either US dollars or Hong Kong dollars. The programme incorporates flexible product features and offering mechanisms for both public issuances and private placements to increase its appeal to investors with different investment horizons and requirements. As at the end of 2012, an extensive dealer group comprising

10 major international and regional financial institutions had been appointed to support future MTN issuance and provide secondary market liquidity.

In 2012, the Corporation launched 50 MTN private debt issues, including debt denominated in Hong Kong dollars, US dollars, renminbi, British pounds, Japanese yen and Singapore dollars, totalling an equivalent of HK$14.9 billion. The Corporation also made a debut public issue of AUD500 million of debt securities under the MTN, which was very well received by a diverse group of Australian and overseas institutional investors including central banks, agencies, investment funds and banks. The issue has set a benchmark for other issuers and also helped to encourage more cross-border funding and investment activities, thereby promoting regional bond market development.

Debt Issuance Programme

The Debt Issuance Programme (DIP) was established in July 1998 to target institutional investors in the Hong Kong dollar debt market. It was set up with an initial programme size of HK$20 billion, which was subsequently increased to HK$40 billion in 2003. The DIP has since provided a flexible and efficient platform for the Corporation to issue debt and transferable loan certificates with a tenor of up to 15 years. As at the end of 2012, a total of six Primary Dealers and 16 Selling Group Members had been appointed under the DIP to provide wide distribution channels for both public and private debt issues.

Retail Bond Issuance Programme

The Corporation is dedicated to promoting the local retail bond market with the objective of extending the Corporation's investor base beyond its already strong institutional investor community. In November 2001, the Corporation successfully pioneered a new offering mechanism for the retail bond market in Hong Kong.

To further spur the development of the retail bond market, the Corporation established the HK$20 Billion Retail Bond Issuance Programme and made its debut issuance in June 2004. Under this programme, placing banks use their retail branch networks, telephone and electronic banking facilities to place debt securities issued by the Corporation with retail investors. To ensure the liquidity of the aforementioned retail bonds, the placing banks are committed to making firm bid prices for the bonds in the secondary market. Since 2001, the Corporation has issued a total amount of HK$13.7 billion retail bonds. Over the years, the Corporation's retail bonds have gained widespread recognition as a safe and simple investment choice, with reasonably attractive returns, giving retail investors an opportunity to invest in high-grade debt securities issued by a wholly government-owned corporation. When the market environment is conducive, the Corporation aims to issue retail bonds regularly to provide an additional investment tool for Hong Kong's retail investors.

Revolving Credit Facility Provided by the Exchange Fund

In January 1998, during the Asian Financial Crisis, the Exchange Fund extended a HK$10 billion Revolving Credit Facility to the Corporation through the HKMA. This Facility enables the Corporation to maintain smooth operation under exceptional circumstances, so that it can better fulfil its mandate to promote banking and financial stability in Hong Kong. While the Corporation obtains long-term funding from local and international debt markets to fund its operations, the Facility also stands as a liquidity fallback for the Corporation. In light of the global financial crisis in 2008, the size of the Facility was subsequently increased to HK$30 billion in December 2008, which demonstrated the HKSAR Government's recognition of the importance of, and further support for, the Corporation.

The Corporation used the Revolving Credit Facility during times of market stress in 1998 and 2008 to partially fund the acquisition of Hong Kong residential mortgage assets from local banks. At both times, the Revolving Credit Facility was fully repaid by funds raised from the Corporation's cost-effective debt issuance when the markets stabilised. In 2012, there were no drawdowns under the Revolving Credit Facility.

Credit Rating

The Corporation's ability to attract investment in its debt securities is underpinned by its strong credit rating, equivalent to that of the HKSAR Government according to S&P and Moody's.

Credit Ratings of the HKMC

	Standard & Poor's		Moody's	
	Short-term	Long-term	Short-term	Long-term
Local Currency (Outlook)	A-1+	AAA (Stable)	P-1	Aa1 (Stable)
Foreign Currency (Outlook)	A-1+	AAA (Stable)	P-1	Aa1 (Stable)

The credit rating agencies have made very positive comments on the Corporation's credit standing. The following comments are extracts from the credit rating reports of S&P and Moody's after their annual surveillance in May 2012:

S&P

"S&P equalises the ratings on HKMC with the rating on the Hong Kong Special Administrative Region. This reflects our expectation of an "almost certain" likelihood of timely and sufficient extraordinary support from the Hong Kong government – the sole owner of HKMC – in events of financial distress… In our view, HKMC's undertaking of additional policy initiatives over the past two years reinforces its integral link with the Hong Kong government."

"Our view is based on the Corporation's prudent credit risk management, good asset quality, and strong liquidity support. The HKMC also has a sound capital base, which its strong earnings in recent years have enhanced."

"The HKMC has a traditional and generally prudent approach to risk management. The Corporation has recognised credit risk as its focus of risk appetite. It has adopted stringent policies, a simple and effective business model and management structure, and various hedging tools to mitigate other types of risks."

"The HKMC's liquidity position is adequately managed… The Corporation also maintains a reasonable level of liquid assets in the form of marketable debt securities, cash and bank deposits, which provides a liquidity fallback."

Moody's

"HKMC's Aa1 rating is predicated on the government's ongoing support for the company as it carries out public policy mandates through its operation, as well as our expectation of extraordinary support from the government during times of economic stress as the company serves as an alternative "lender of last resort" to the banking system."

"The government provides HKMC with ongoing liquidity and capital support in the form of HKD30 billion revolving credit facility and HKD1 billion of shareholder capital callable on demand. In the event HKMC's credit profile is weakened in a stress scenario, Moody's expects the government to provide timely extraordinary support."

"HKMC has consistently maintained sound asset quality since its establishment… Hong Kong residential mortgages have historically performed very well. Even when property values fell up to 70% between the Asian financial crisis in 1997 and the SARS epidemic in 2003, overall mortgage delinquencies never exceeded 2%. Current average loan to value ratios on HKMC's Hong Kong mortgage portfolio is below 50%, and debt servicing burdens for mortgage borrowers should remain manageable even if interest rates rise by a few percentage points."

"As a wholesale funded entity without any deposit franchise, HKMC relies on ongoing access to the debt capital markets to fund its operation. Nevertheless, the company maintains a very strong liquidity profile during normal economic conditions. It has very good access to capital markets due to its strong financial fundamentals and government affiliation. In addition, the company has sufficient liquid assets and available contingent credit facility from the government to repay all of its outstanding debts as of end-2011."

Mortgage-Backed Securitisation

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

The Corporation has issued a total of HK$13.2 billion MBS since 1999. The US$3 billion Bauhinia Mortgage-Backed Securitisation Programme was established in 2001 to provide a convenient, flexible and cost-efficient platform for the Corporation to issue MBS with various product structures, credit enhancements and distribution methods.

Risk Management

The Corporation operates under prudent commercial principles; and the principle of "prudence before profitability" guides the design of the overall risk management framework and discipline it uses in its day-to-day business execution. Over the years, the Corporation has continuously made refinements to its well-established, robust and time-tested risk management framework to reflect changes in the markets and business strategies.

Corporate Risk Management Committee

The Board is the highest decision making authority of the Corporation and holds the ultimate responsibility for risk management. The Board, with the assistance of the Corporate Risk Management Committee (CRC), has the primary responsibility for formulating risk management strategies in the risk appetite statement and for ensuring that the Corporation has an effective risk management system to implement these strategies. The risk appetite statement defines the constraints for all risk-taking activities and these constraints are incorporated into risk limits, risk policies and control procedures that the Corporation follows to ensure that the risks are properly managed.

The CRC is responsible for overseeing the Corporation's various types of risks, reviewing and approving high-level risk-related policies, overseeing their implementation, and monitoring improvement efforts in governance, policies and tools. It also assigns priorities and responsibilities to individual departments to enhance the risk management framework. The Committee is chaired by an Executive Director, with members including another Executive Director, as well as Chief Executive Officer, Senior Vice President (Operations), Senior Vice President (Finance), General Counsel, Senior Vice President (Risk), and senior staff from the Risk Management Department.

The major types of risk the Corporation manages are credit risk, market risk, operational risk, legal risk, leveraging risk and longevity risk.

Credit Risk

Credit risk is the Corporation's primary risk exposure. It represents the default risk presented by loan borrowers and counterparties.

(a) Default risk

To address default risk effectively, the Corporation adopts a four-pronged approach to safeguard and maintain the quality of its assets, MIP and SME guarantee portfolios:

- Careful selection of Approved Sellers, Servicers, Reinsurers and Lenders
- Prudent asset purchase, insurance and guarantee application eligibility criteria
- Effective due diligence process for mortgage purchase, default loss, insurance and guarantee claims
- Enhanced protection for higher-risk mortgages and transactions

Losses may arise if there are shortfalls in the recovery amount received for defaulted loans that fall under the Mortgage Purchase Programme (MPP). To mitigate this default risk, the Corporation adopts prudent loan purchase criteria and conducts effective due diligence reviews as part and parcel of the loan purchase process in order to maintain the credit quality of loans. In addition, depending on the projected risk exposure of each underlying loan portfolio, credit enhancement arrangements, such as reserve funds for absorbing credit losses, are agreed upon with sellers on a deal-by-deal basis to reduce the potential credit losses that could arise from the borrower's default.

Losses may also arise from default on loans under the MIP's insurance coverage. Each MIP application is underwritten by the Corporation in accordance with a set of eligibility criteria, and each claim from a participating bank is audited by the Corporation to ensure the fulfilment of all MIP coverage conditions and to detect any fraud elements. As a result, the default risk for loans with MIP coverage has been greatly reduced. To reduce the risk of possible concentration of this default risk, the Corporation transfers a portion of the risk-in-force to Approved Reinsurers via reinsurance risk-sharing and excess-of-loss arrangements.

The Corporation adopts a three-pronged approach to manage the default risk under the Microfinance Scheme, which includes (a) prudent assessment of borrowers' repayment capability; (b) a vetting panel to consider business viability and approval of the loan applications; and (c) provision of training and mentoring support to borrowers.

Portfolio performance and analysis reports are compiled on a regular basis to provide management with updated information on critical credit risk indicators, such as loan delinquency ratios, equity positions and cumulative credit losses, to enable timely reviews and a swift response to changes in the operating environment.

Stress tests are also conducted to analyse the Corporation's financial capability to weather extreme scenarios when they arise.

(b) Seller/Servicer counterparty risk

Counterparty risks may arise from the failure of a Seller/Servicer of an acquired portfolio to remit scheduled payments to the Corporation in a timely and accurate manner. The Corporation has adopted a counterparty risk limit framework that limits the aggregate amount of assets it can purchase from the Approved Sellers. There are also individual limits set on the maximum amount of assets that the Corporation can purchase from a counterparty. The risk limit framework acts as a beneficial device for managing counterparty exposure on the risk profile basis of each Seller/Servicer and for avoiding the concentration of acquisition from only a few Sellers.

The Sellers/Servicers are subject to regular review, where their financial strengths, management capabilities, loan servicing quality and transaction experience are taken into consideration in the review.

(c) Reinsurer counterparty risk

Reinsurer counterparty risk refers to the failure of an Approved Reinsurer to make claim payments to the Corporation. In order to mitigate reinsurer counterparty risk effectively, the Corporation has established a framework for the assessment of each mortgage reinsurer's financial strength, credit rating and relevant experience in mortgage insurance.

The Corporation performs an annual review of each Approved Reinsurer's financial strength, business proposal, reinsurance arrangements and management capabilities. The review results are used to determine the ongoing business allocation and risk-sharing portions. The Corporation also has collateral arrangements with Approved Reinsurers to reduce counterparty risk exposures.

(d) Treasury counterparty risk

Treasury counterparty risk arises when there is a delay or failure from treasury counterparties to make payments with respect to treasury instruments transacted with the Corporation. Hence, the Corporation has adopted a prudent treasury counterparty limit framework, under which each potential treasury counterparty is assessed on the basis of its credit rating, financial strength and capability in treasury products, etc. Based on the evaluation results, a treasury counterparty limit is assigned for each specific type of treasury instrument exposure. The limits for treasury counterparties are reviewed and adjusted on a regular basis, which are based on their financial strength and the capital base of the Corporation. To date, the Corporation has not experienced any loss on a treasury transaction due to a credit default by a counterparty.

(e) Lender risk

The Corporation is exposed to lender risk in SME lending that arises from: (a) a lender's underwriting being incompliant with its credit policy; (b) a lender's loosely formulated credit policy which is not specific enough or sufficiently defined for compliance; and (c) the moral hazard of a lender being less prudent in underwriting a guarantee protected application. The Corporation adopts prudent eligibility criteria for application vetting, monitors delinquency and workout plans, and conducts due diligence reviews on claims to mitigate default risk on the part of borrowers and moral hazard on the part of lenders.

At the heart of the Corporation's credit risk management framework are two committees: the Credit Committee and the Transaction Approval Committee.

Credit Committee

The Credit Committee is responsible for setting the Corporation's overall credit policies and eligibility criteria, particularly for asset acquisition, mortgage insurance, SME guarantee business and Microfinance Scheme. The Committee operates under a framework that has been approved by the Board. The Committee is the approval authority for accepting applications to become Approved Sellers/Servicers under the MPP, Approved Reinsurers under the MIP, Approved Lenders under SFGS and eligible treasury counterparties. It is also responsible for setting risk exposure limits for the counterparties. Should the business and operating environment change drastically, credit policies will be immediately subject to review and timely measures based on the findings will be presented to the Committee for approval.

Transaction Approval Committee

The Transaction Approval Committee conducts an in-depth analysis of pricing economics and associated credit risks for business transactions, whilst taking into consideration the latest market conditions and business strategies approved by the Board. Major transactions approved by the Committee are subject to endorsement by an Executive Director.

The Credit Committee and the Transaction Approval Committee are both chaired by the Chief Executive Officer, with members including Senior Vice President (Operations), Senior Vice President (Finance), General Counsel, Senior Vice President (Risk) and senior staff from the relevant functional departments.

Market Risk

Market risks arise when the Corporation's income or the value of its portfolios decreases due to movements in market prices. Market risk consists of interest rate risk, asset-liability maturity mismatch risk, liquidity risk and currency risk.

(a) Interest rate risk

Net interest income is the predominant source of earnings for the Corporation. It represents the excess of interest income (from the Corporation's loan portfolio, cash and debt investments) over interest expenses (from debt issuance and other borrowings). Interest rate risks arise when changes in market interest rates affect the interest income associated with the assets and/or interest expenses associated with the liabilities.

The primary objective of interest rate risk management is therefore to limit the potential adverse effects of interest rate movements on interest income/expense, while maintaining stable earnings growth. The interest rate risk faced by the Corporation is two-fold, namely interest rate mismatch risk and basis risk. Interest rate mismatch risk is the most substantial risk affecting the Corporation's net interest income. It arises mainly as a result of the differences in the timing of interest rate re-pricing for the Corporation's interest-earning assets and interest-bearing liabilities. Interest rate mismatch risk is most evident in the loan portfolios where the majority of the loans earn a floating interest rate (benchmarked against the Prime rate, HIBOR or Composite Interest Rate), whilst the majority of the Corporation's liabilities are fixed-rate debt securities. The Corporation therefore makes prudent use of a range of financial instruments, such as interest rate swaps, interest rate swaptions, basis swaps, forward rate agreements and issuances of MBS, to manage interest rate mismatch risk. The proceeds of the fixed-rate debt securities are generally swapped into HIBOR-based funds via interest rate swaps in order to better match the floating-rate incomes from mortgage assets.

The Corporation also uses duration gap as an indicator to monitor, measure and manage interest rate mismatch risks. A duration gap measures the difference in interest rate re-pricing intervals between assets and liabilities. The wider the duration gap, the higher the interest rate mismatch risk. A positive duration gap means that the duration of assets is longer than that of the liabilities, and therefore, represents greater risk exposure to rising interest rates. A negative duration gap, in contrast, indicates greater risk exposure to declining interest rates.

Depending on the prevailing interest rate outlook and market conditions, the Corporation proactively re-balances the duration gap of its asset-liability portfolio under the guidance and supervision of the Asset and Liability Committee (ALCO). A cap of three months for the duration gap has been set to limit interest rate mismatch risks. In 2012, the average duration gap was kept at below one month, indicating that the Corporation handles interest rate mismatch risk in a very effective manner.

Basis risk represents the difference in the Corporation's Prime-based interest-earning assets and its HIBOR-based interest-bearing liabilities. However, there are only limited financial instruments currently available in the market to hedge the Prime-HIBOR basis risk fully. In general, basis risk can be effectively addressed only when mortgage assets and non-mortgage assets are based on HIBOR to match the funding base, or when related risk management instruments become more prevalent or economical. Over the past few years, the Corporation has consciously adopted a strategy that acquires more HIBOR-based assets. At the end of 2012, about 70% of the Corporation's mortgage assets and non-mortgage assets were HIBOR-based loans. As a result, the Prime-HIBOR basis risk for the Corporation has been substantially reduced. In addition, the Corporation had issued Prime-based MBS and used hedging derivatives in the past to mitigate such basis risk.

(b) Asset-liability maturity mismatch risk

Even though the contractual maturity of a mortgage loan can be up to 30 years, the actual average life of a portfolio of mortgage loans is much shorter. The average life depends on the speed of scheduled mortgage repayments and unscheduled prepayments. Higher prepayment rates shorten the average life of a portfolio of mortgage loans. In Hong Kong, prepayment occurs for two main reasons: (i) housing turnover – borrowers repaying their mortgage loans upon the sales of the underlying properties, and (ii) refinancing – borrowers refinancing their mortgage loans to obtain lower mortgage rates.

Asset-liability maturity mismatch risk can be more specifically characterised as reinvestment risk and refinancing risk. Reinvestment risk refers to the risk of a lower return from the reinvestment of proceeds that the Corporation receives from prepayments and repayments of its loan portfolio. Refinancing risk is the risk of refinancing liabilities at a higher level of interest rate or credit spread. The Corporation is exposed to refinancing risk (in both funding amount and cost of funds) when it uses short-term liabilities to finance long-term, floating-rate loan portfolios.

Reinvestment risk is managed through the ongoing purchase of new loans to replenish the rundown in the retained portfolios and through the investment of surplus cash in debt securities or cash deposits to fine tune the average life of the overall assets pool. In addition, the Corporation makes use of the issuance of callable bonds and transferable loan certificates to mitigate reinvestment risk. The call option included in callable bonds and transferable loan certificates allows the Corporation to adjust the average life of its liabilities to match more closely that of the overall pool of assets.

The Corporation manages its refinancing risk through the flexible debt securities issuance with a broad spectrum of maturities, ranging from one month to 15 years. This again serves to adjust the average life of the overall liability portfolio in a dynamic fashion. In addition, refinancing risk can be mitigated by adjusting the maturities of assets in the investment portfolio or off-loading mortgage assets through securitisation of mortgage loans into MBS.

The asset-liability maturity gap ratio (ratio of the average life of the total interest-earning assets to the average life of the total interest-bearing liabilities) is used to monitor and manage maturity mismatch risk, with a target ratio set by the ALCO to ensure a proper balance between the average life of the Corporation's assets and liabilities.

(c) Liquidity risk

Liquidity risk represents the risk of the Corporation not being able to repay its obligations, such as the redemption of maturing debt, or to fund the committed purchases of loan portfolios. The Corporation implements its liquidity risk management framework in response to changes in market conditions. The Corporation has continuously monitored the impact of recent market events on its liquidity positions, and has pursued a prudent pre-funding strategy which has helped to contain the impact the global financial turmoil had on its liquidity. Liquidity risk is managed by monitoring the daily inflow and outflow of funds, and by projecting the longer-term inflows and outflows of funds across the full maturity spectrum. The Corporation measures its liquidity risk using a target liquid-asset ratio (ratio of liquid assets to total assets), set by the ALCO to monitor and manage its liquidity position.

The Corporation manages pre-funding prudently through well-diversified funding sources, so that all foreseeable funding commitments are met when they fall due, in order to support the growth of its business and the maintenance of a well-balanced liability portfolio. Such diversification allows the Corporation to pursue a prefunding strategy at the lowest possible cost, whilst at the same time offering safeguards against the inability to raise funds in distorted market conditions. The current funding sources are illustrated in Table 1 below:

Table 1: The Current Funding Sources for the HKMC

Funding Source	Description
US$6 Billion Medium Term Note (MTN) Programme	There are 10 Dealers who underwrite and distribute local and foreign currency debt to international institutional investors under the programme
HK$40 Billion Debt Issuance Programme (DIP)	There are 6 Primary Dealers and 16 Selling Group Members which underwrite and distribute debt to institutional investors under the DIP. The Transferable Loan Certificate Sub-Programme under the DIP provides further diversification of its funding sources and broadening of its investor base
HK$20 Billion Retail Bond Issuance Programme	This debt issuance programme has 19 Placing Banks which assist in offering retail bonds to investors
US$3 Billion Bauhinia Mortgage-Backed Securitisation Programme	With a total of 8 Dealers, this multicurrency mortgage-backed securitisation programme permits the Corporation to originate MBS in both the local and international markets
Cash and Debt Investment Portfolio	This portfolio comprises mainly cash and bank deposits, commercial paper, high-quality certificates of deposit, and notes that are readily convertible into cash
Money Market Lines	The Corporation has procured money market lines from a large number of local and international banks for short-term financing
HK$30 Billion Revolving Credit Facility	The Exchange Fund commits to providing the Corporation with HK$30 billion in revolving credit

Given its strong background as a wholly government-owned entity and its solid credit rating, the Corporation is efficient in raising funds from debt markets with both institutional and retail funding bases. This advantage is supplemented by the Corporation's portfolio of highly liquid investments, which are held to enable a swift and smooth response to unforeseen liquidity requirements. The HK$30 billion Revolving Credit Facility from the Exchange Fund further provides the Corporation with a liquidity fallback even if exceptional market strains last for a prolonged period.

(d) Currency risk

Currency risk arises from the impact of foreign exchange rate fluctuations on the Corporation's financial position and foreign-currency-denominated cash flows. The Corporation manages its currency risk in strict accordance with the investment guidelines approved by the Board and under the supervision of the ALCO, which sets daily monitoring limits on currency exposure.

In accordance with this prudent risk-management principle, the net exposure of the foreign currency denominated debts issued under the MTN Programme and the overseas residential mortgage loans purchased is fully hedged by the use of cross-currency swaps.

Control mechanism

Transaction execution is segregated among the front, middle and back offices to ensure adequate checks and balances. The Treasury Department, acting as the front office, is responsible for monitoring financial market movements and executing transactions in the cash, derivatives, debt and securitisation markets, in accordance with the strategies laid down by the ALCO. The Financial Control Department, assuming the middle-office role, monitors compliance with treasury counterparties and market risk limits. The Operations Department, acting as the back office, is responsible for deal verification, confirmation, settlement and the payment process.

Asset and Liability Committee

The ALCO is responsible for the overall management of market risks of the Corporation. It follows the prudent risk management principles and the investment guidelines approved by the Board. It is responsible for reviewing and managing the market risk of interest rate risk, asset-liability maturity mismatch risk, currency risk, liquidity and funding risk of the Corporation. Regular meetings are held to review the latest financial market developments and formulate relevant asset-liability management strategies for the Corporation.

The ALCO is chaired by the Chief Executive Officer, and has among its members a Senior Vice President (Finance), Senior Vice President (Operations), Senior Vice President (Risk) and senior staff from the relevant functional departments.

Operational Risk

Operational risk represents the risk of losses arising from external interruptions, or inadequacies or the failure of internal processes, people or systems.

The Corporation adopts a bottom-up approach in identifying operational risk by carrying out an in-depth analysis of new products, business activities, processes, system enhancements and due diligence reviews of new operational flows. Comprehensive validation rules, management information system reports and audit trails are in place to track and report any errors or deficiencies.

The Corporation actively manages operational risk with its comprehensive system of well-established internal controls, authentication structures and operational procedures. The operational infrastructure is well designed to support the launch of new products in different business areas, including asset acquisition, mortgage insurance, SME guarantee, reverse mortgages, microfinance loans, treasury operations, debt issuances and overseas businesses. Rigorous reviews are conducted before the implementation of operational or system infrastructure in order to identify possible operational risks and to ensure adequate segregation of duties.

To prevent potential human error, and to ensure an efficient and effective discharge of daily operations, the Corporation pursues advanced technological solutions alongside robust business logistics and controls to carry out its operational activities and business processes. Steps have been taken to ensure the accuracy, availability and security of these systems, as they are critical to business operations and risk management. The Corporation has also taken cautious steps to institute adequate checks and balances in financial controls to ensure that its operations are properly directed and controlled. Effective financial controls also help to minimise financial risk and safeguard its assets against inappropriate use or loss, including the prevention and detection of fraud.

The Corporation's Information Security Manual (ISM) documents security standards and practices relating to information and data security for observance by all staff. All system security measures must follow the requirements stated in the ISM. The Corporation implements various security measures, such as double firewall protection, intrusion-detection systems, virus alerts, quarantine systems and vulnerability scanning systems to minimise its exposure to external attacks. Internally, the Corporation also has a virtual Local Area Network with workstation security policies to reduce damage in the event of a malicious intrusion. The Corporation engages external consultants when appropriate to conduct intrusion vulnerability tests in order to enhance system security.

To ensure a high degree of compliance, the Corporation's core operating systems and processes are subject to regular audit and review by internal auditors. As part of the annual statutory audit, these systems are also subject to external auditors' review. Furthermore, every year all staff are required to sign an undertaking to comply with the requirements in the ISM. The ISM is updated whenever there is a new security measure or system. Any changes to the ISM require approval from senior management.

Business Continuity Plan

The Corporation's business recovery plan ensures that maximum possible service levels are maintained at all operation units to support business continuity and minimise the impact of business disruption from different disaster scenarios. Each business unit assesses the impact of disaster scenarios and updates recovery procedures from time to time. To ensure that business recovery procedures are practical, a business recovery drill is conducted by both IT and user departments annually. Daily back-ups and offsite storage of back-up tapes are in place to protect the Corporation from IT disasters.

Product Sign-off Mechanism

To ensure that all risk factors are considered when designing and implementing a new product, the Corporation developed a new product development management framework under which proper sign-off of product specification is conducted prior to any new product launch. The product driver is clearly assigned at the start of the product development process to be responsible for instituting the sign-off process. Products can only be launched after all functional departments have signed off and confirmed functional readiness.

Complaint Handling Mechanism

The Corporation makes continuous effort to improve its core processes to ensure that its products and services meet customers' expectations. To make sure customers' feedback is attended to in a timely and appropriate manner, the Corporation has put in place a formal complaint handling mechanism to improve the tracking, reporting and handling of complaints. An automated complaint handling system is expected to be in place in 2013 to further strengthen the work in this area.

Operational Risk Committee

The Operational Risk Committee (ORC) is responsible for ensuring that all business entities and line functions in the Corporation maintain an effective operational risk and internal control framework. The ORC is also responsible for providing directions and resolving issues related to policies, controls and management of operational issues referred to by line functions, as well as ensuring prompt and appropriate corrective action in response to audit findings related to operational risks or internal controls.

The ORC is chaired by the Chief Executive Officer. Other members of the committee include Senior Vice President (Operations), Senior Vice President (Finance), General Counsel, Senior Vice President (Risk) and senior staff in the relevant functional departments.

Legal Risk

Legal risk arises from uncertainty in the application or interpretation of laws, regulations and legal documents, or failure to comply with statutory, regulatory or legal obligations. Legal risk also arises from the unenforceability or ineffectiveness of legal documents or specific provisions therein intended to safeguard the interests of the Corporation.

The Legal Office, headed by General Counsel and Company Secretary, advises the Corporation on legal matters with a view to controlling legal risk. When new products or business activities are considered, the Legal Office will advise on the relevant laws (and the updates thereafter) and regulatory environment, as well as the legal documentation, and identify possible legal pitfalls with a view to protecting the best interests of the Corporation. Where appropriate, external counsel will be engaged to assist the Legal Office in providing full legal support to the Corporation. The Legal Office also works closely with the other departments of the Corporation to advise on legal issues and documentation.

The ORC is the governance committee for legal risks.

Leveraging Risk

In order to ensure that the Corporation would not incur excessive risk when expanding its business and balance sheet in relation to its own capital base, the Financial Secretary, in his capacity as Financial Secretary and not the shareholder, acted as the regulator of the Corporation, by issuing a set of guidelines on capital-to-asset ratio for compliance by the Corporation upon the establishment of the Corporation in 1997. The guidelines have since been updated from time to time to take account of new products launched by the Corporation. The Financial Secretary issued in October 2011 a new set of guidelines by reference principally to the Basel II risk-based capital adequacy framework, the Guidelines on Capital Adequacy Ratio (CAR), which took effect on 31 December 2011. The minimum CAR stipulated in the new Guidelines is 8%, which is the same minimum capital requirement under the Basel II. As at 31 December 2012, the Corporation had a capital base of HK$8.6 billion and a CAR of 20.2%.

The prudent use of regulatory capital is monitored daily in accordance with the new capital guidelines. The Chief Executive Officer (CEO) reports the CAR and the daily minimum ratio to the Board of Directors on a quarterly basis. An early warning system is also in place. If the CAR drops to the threshold level of 14%, the CEO will alert the Executive Directors. If the CAR falls to 12% or below, the Board of Directors will be informed and appropriate remedial actions will be taken.

Longevity Risk

Longevity risk refers to the heightening risk of larger payouts under the Reverse Mortgage Programme. The longer the payout period is, the larger the loan balance will be over time, and the less buffer there will be for the sale of the property to cover the outstanding loan balance. A loss may arise if there is a shortfall in the recovery amount after the disposal of the property. The termination rate of the loans depends largely on the mortality rate (i.e. life expectancy) of the borrowers.

Annual risk analysis is conducted in order to assess the potential financial impact of longevity risk for Reverse Mortgage loans, as well as the interaction among the various risk factors under the Reverse Mortgage Programme. The mortality assumptions are reviewed on a regular basis by the Transaction Approval Committee.

Process Management and Information Technology

Automation is instrumental in ensuring efficiency and accuracy in daily operations. Since its inception, the Corporation has devoted substantial resources and effort to developing and upgrading its business operations, internal controls and application systems.

A new treasury system was successfully rolled out in 2012 after satisfactory completion of comprehensive testing and a parallel run with the existing treasury system. The new system facilitates the timely development of new treasury and hedging products. The Corporation is also developing the other treasury risk system to have better risk management surveillance and integration across various products, counterparts and regions; and more robust and responsive adaptations to meet future regulatory and reporting requirements.

In 2012, the Corporation further automated the SFGS operations to support the new 80/20 loan guarantee products. The system can provide internal control and process automation for application processing, post-commitment monitoring, guarantee fee administration, claim processing and management reporting for SFGS. The existing internet-based business platform has also been enhanced to facilitate straight-through processing for handling high application volume of the new SFGS products. This e-platform system has enabled the Corporation and SFGS participating lenders to operate at higher efficiency by automating the workflows, enhancing the quality of application processing and shortening the application turnaround time.

To support the launch of the MF Scheme in July 2012, the Corporation developed the microfinance application systems to facilitate the loan application processes and servicing operations for both the pilot banks and the Corporation. The pilot banks can opt to use the system to serve their microfinance clients.

Further system modifications on the reverse mortgage system have been implemented for handling the enhanced features of the Reverse Mortgage Programme introduced in November 2012.

Corporate Social Responsibility

In recognition of the Corporation's contribution to the community and its commitment to corporate social responsibility (CSR) in the past years, the Corporation has been awarded the Caring Organisation Logo by the Hong Kong Council of Social Service since 2008 and has now stepped into the fifth year of CSR participation.

Caring Company Recognition Ceremony

As a socially responsible organisation, the Corporation cares for both its employees and the community. The Corporation has underlined its commitment to corporate social responsibility by caring for its employees' well-being, participating in charity activities and implementing environmental protection measures.

Care for Employees

Staffing and Remuneration

The Corporation attracts and grooms talent to ensure the efficient performance of its core mission of enhancing stability in the banking sector, promoting wider home ownership and facilitating the development of the debt securities market. Employees are provided with competitive remuneration packages and fringe benefits, a promising career path and development opportunities, and a healthy and safe working environment. The Corporation has also adopted family-friendly practices by offering a five-day week to help employees maintain a good work-life balance, as well as comprehensive medical and dental insurance plans which cover both the employees and their family members.

Through systems automation and process re-engineering, the Corporation has maintained a lean and efficient workforce, despite an increase in the scope of purchases and the complexity of the products it offers. In 2012, the permanent staff establishment of the Corporation was 178, and the staff turnover rate was 8.31%.

Training and Development

The Corporation recognises the importance of ongoing training and has devoted considerable resources to the continuous enhancement of its employees' professional knowledge and skills. In 2012, the Corporation arranged different programmes and workshops to help employees enhance their product knowledge, and strengthen their managerial and technical competence and soft skills.

The in-house training workshops covered a wide range of topics such as treasury counterparty risk management, effective communication, planning and organising, negotiation in handling crisis, etc. A management development programme was also introduced to strengthen the managerial competence of senior staff members. Language courses were held on business writing, and IT desktop workshops were organised on software applications.

Negotiation in Handling Crisis Seminar

Effective Planning and Organising Workshop

Management Development Programme

The Corporation also sponsored employees for external job-related training and development courses covering a wide range of topics, from mortgage-related issues, risk management, corporate governance, finance and accounting to information technology and leadership training.

In addition, all new employees were provided with an induction session to help them develop a positive working relationship by building a foundation of knowledge about the Corporation's organisation structure, functions and policies.

Health and Safety

As a caring organisation, the Corporation is dedicated to looking after both the physical and mental health of its employees. An Employee Support Programme is in place to provide confidential external counselling and consultation services to employees and their family members, if needed. A vaccination programme for the prevention of influenza and health-check programmes at privileged rates were also offered to employees.

The Corporation has further reviewed and strengthened its contingency plans, such as split-team arrangements, to ensure an immediate response to a possible outbreak of influenza. The contingency plans aim to prevent the spread of communicable diseases among employees and to minimise any unexpected or sudden disruption to business operations. Periodic drills are organised to make sure employees are conversant with the activation of the back-up facilities, contingency plans and communication arrangements in case of emergency.

Employee Relations and Staff Activities

To promote a healthy work-life balance and foster a family-friendly working environment, the HKMC Staff Club regularly organises staff activities to cultivate better relationships and communication among employees. In 2012, these activities included social outings, barbecue gatherings, interest classes, Work-Life Balance Week, and other staff gatherings, all of which were well received by employees and their families. Our employees also participated in friendly table-tennis games with other organisations for fun and team building. The e-newsletter "Mind Channel" regularly disseminates short stories, epigrams and health tips to all employees to create and maintain an optimum work-life balance and fulfilment.

Night Squid Fishing Tour

Barbecue gathering

To facilitate effective communication within the Corporation, the intranet Staff Homepage is frequently updated so that useful information can be shared among different departments. There is also the Staff Suggestion Scheme, which encourages staff to make suggestions for improvements in work flow and the workplace.

Care for the Community

Charities and Social Activities

The Corporation promotes various charitable and community functions, such as fund-raising events, donation campaigns and voluntary services. Employees are encouraged to support charity activities and join voluntary work organised by the HKMC Volunteers Team, Caring League.

In 2012, the Corporation organised donation campaigns, such as Dress Casual Day 2012 for the Community Chest and the HKMC charity concert for education projects on the Mainland, and held its annual Blood Donation Day event for the Hong Kong Red Cross, part of the Corporation's community programme.

Dress Casual Day

Employees have been keen to participate in voluntary services, demonstrating their concern for the needy by dedicating time and effort to various causes. The Caring League has partnered with several social service organisations to participate in a number of voluntary services, including the following:

- Care for the environment – a recycling campaign in partnership with the Salvation Army to collect books, stationery, toys, etc.

Recycling Campaign

- Care for the elderly – organised by HOPE *worldwide* and the Mongkok Kai Fong Association Ltd – Chan Hing Social Service Centre respectively, involving our volunteers visiting the homes of elderly people living alone and bringing them "lucky bags" with daily necessities to welcome the Chinese New Year and Mid-Autumn Festival.

Visiting the Elderly

"Lucky Bags" for the Elderly

- Care for the children – organised by HOPE *worldwide*, our volunteers accompanied children from low income families to practise oral English with foreigners and to look for appropriate level of English reading books at bookstores.

Practising Oral English with Children

Selecting English books with Children

Student Internship and Executive Trainee Programmes

To help nurture talent for the future, the Corporation provides a number of internship and placement programmes for undergraduates to give them a taste of the real business world and help them better prepare for their future careers. The students who joined the programmes appreciated the learning experience and incredible work opportunities they were exposed to.

In 2012, the Corporation launched its second Executive Trainee Programme with the objective of attracting young executives with good potential to meet the Corporation's operational needs and long-term staff development plan. Throughout the two-year programme, the Executive Trainees have the opportunity to undergo job rotations and attend structured learning and development programmes from time to time.

Environmental Protection

The Corporation continuously supports and implements various green measures to create a more environmentally friendly office and raise employees' awareness of methods of waste reduction and energy conservation. In 2012, the Corporation organised a Green Office Campaign during which useful green tips were shared among employees. Employees are encouraged to adopt paperless working practices by using more electronic communication. They are also encouraged to collect waste paper and used toner cartridges for recycling, and are reminded to switch off their computers before leaving the office. Since 2006, the Corporation has taken various measures, including better control of office temperature, in the interest of energy efficiency. The Corporation welcomes suggestions from employees for green office ideas and encourages its suppliers to use and offer more environmentally friendly products whenever possible.