# Healthy and Sustainable Growth

# Financial Review

Amid increasing headwinds on the external front caused by the prolonged sovereign debt crisis in the Eurozone, anaemic recovery in the US economy, and the continuation of macro-economic control measures in the Mainland, the growth momentum of the Hong Kong economy trended downward in the second half of 2011. Total exports of goods suffered, relapsing to a modest year-on-year decline due to sluggish demand from advanced economies. However domestic demand held up remarkably well and was the key growth driver for the local economy. Private consumption expenditure grew robustly as wages and incomes showed accelerated increases across almost all segments of the workforce, and the labour market was virtually in full employment, with the unemployment rate falling to 3.3% from October to December. Overall investment spending posted a double-digit increase in 2011, backed by strong machinery and equipment acquisition and infrastructure construction. The real GDP recorded year-on-year growth of 5%.

Inflationary pressure remained elevated in recent months, driven mainly by the food and housing rental components. Inflation momentum, however, showed some signs of moderation amid a slight easing in food price increases. However, lagging effects from the earlier surge in private housing rentals continued to filter through, and wages also picked up visibly on the back of a tight labour market. Headline consumer price inflation still rose from 5.2% in the second quarter to 5.7% in the fourth quarter. The residential property market cooled down in the second half, reflecting the combined impact of a weaker global growth outlook, the Government's housing initiatives, rising mortgage interest rates and stronger headwinds in the external environment. However, overall residential property prices still increased by 9% in 2011.

## Income Statement

### Financial Performance

Benefiting from the growth of the Hong Kong economy and the buoyant property market in first half 2011, the Corporation achieved another year of good financial results. Profits attributable to the shareholders grew 1.8% over 2010 to HK$1,256 million in 2011 **(Figures 1 and 2)**. The growth was attributable mainly to the low interest rate environment, excellent loan performance and an increased contribution from the mortgage insurance premium earned from loans under the Mortgage Insurance Programme ("MIP").

**Figure 1**

**Summary of financial performance**

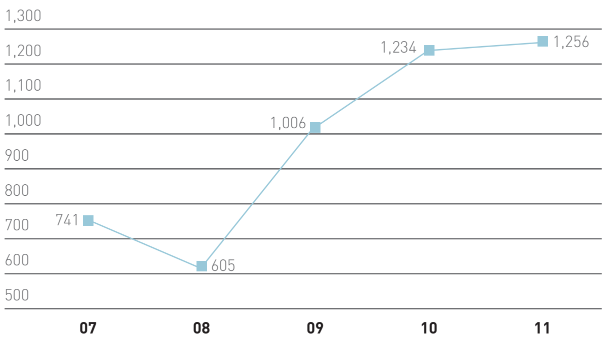
| | 2011 HK$ million | 2010 HK$ million |
|---|---|---|
| Operating profit before impairment | 1,429 | 1,387 |
| Profit before tax | 1,429 | 1,406 |
| Profit attributable to shareholders | 1,256 | 1,234 |
| Return on shareholders' equity | 15.5% | 17.5% |
| Return on assets | 2.3% | 2.2% |
| Cost-to-income ratio | 11.8% | 11.0% |
| Capital adequacy ratio/ Capital-to-assets ratio[1] | 19.7% | 10.8% |

1 The capital adequacy ratio as at 31 December 2011 was compiled in accordance with Guidelines on Capital Adequacy Ratio stipulated by the Financial Secretary, replacing the previous Guidelines on Capital-to-Assets Ratio adopted for 2010. As there are modifications between the two guidelines, the capital ratios are not directly comparable.

Operating profit before impairment increased by HK$42 million, or 3%, to HK$1,429 million. This was supported by 36.1% growth in the net mortgage insurance premium earned and 16.5% growth in other income, offsetting a reduction of 11.9% in net interest income.

**Figure 2**

**Profit attributable to shareholders** (HK$ million)




Return on shareholders' equity remained stable at 15.5% (2010: 17.5%), as did return on assets at 2.3% (2010: 2.2%). Increased commitments for risk management infrastructure and resources to support the launch of the SME Financing Guarantee Scheme and Reverse Mortgage Programme in January and July 2011 respectively contributed to the increase of 12.3% in operating expenses. The cost-to-income ratio increased to 11.8% (2010: 11.0%) and the capital adequacy ratio ("CAR") was at 19.7% as at 31 December 2011, well above the minimum 8% guideline stipulated by the Financial Secretary.

**Figure 3**

**Net interest income**

| | 2011 HK$'000 | 2010 HK$'000 |
|---|---|---|
| Interest income | 1,032,602 | 1,141,383 |
| Interest expense | (177,789) | (170,802) |
| Net interest income | 854,813 | 970,581 |
| Average interest-earning assets | 51,518,005 | 53,266,677 |
| Net interest margin | 1.7% | 1.8% |
| Net interest spread on interest-bearing liabilities[2] | 1.6% | 1.8% |

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

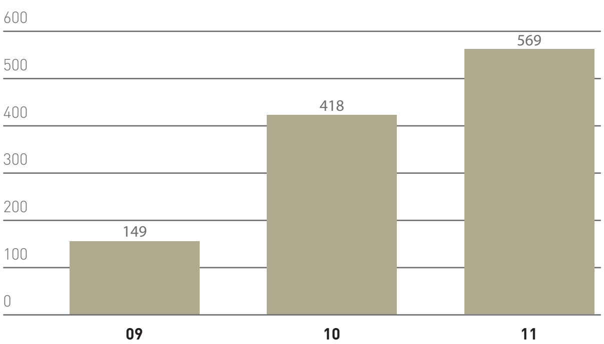
The average loan portfolio fell HK$5.5 billion compared to that of 2010 as a result of faster loan portfolio runoffs arising from the increased housing turnover in the property market. This reduction was offset partially by an increase in cash and investments of HK$3.7 billion. The net interest spread fell from 1.8% to 1.6% year on year, and the net interest margin dropped from 1.8% to 1.7%. The net interest income for the year declined 11.9%, from HK$971 million to HK$855 million year on year on account of a HK$1.7 billion reduction in average interest-earning assets in 2011 **(Figure 3)**.

## Net Mortgage Insurance Premium Earned

Following the slowdown in the property market in the second half of 2011 amidst the impact of a weaker global growth outlook, rising mortgage interest rates and stronger headwinds in the external environment, new residential mortgage loans drawn down decreased from HK$324.2 billion in 2010 to HK$227.8 billion in 2011. The Corporation's new business underwritten under the MIP dropped from HK$41 billion to HK$26.3 billion year on year. However, the amortisation effect of premium receipts underwritten in previous years added to the upfront premium recognised due to active housing turnover during first half of 2011, leading to an increase of 30% in net premiums earned after net commission expenses from HK$424 million in 2010 to HK$550 million in 2011. Taking into account the write-back of provisions for outstanding claims of HK$19 million (2010: a charge of HK$6 million), the net premiums earned after provisions increased 36.1% year on year from HK$418 million to HK$569 million **(Figure 4)**.

**Figure 4**

**Net mortgage insurance earned** (HK$ million)



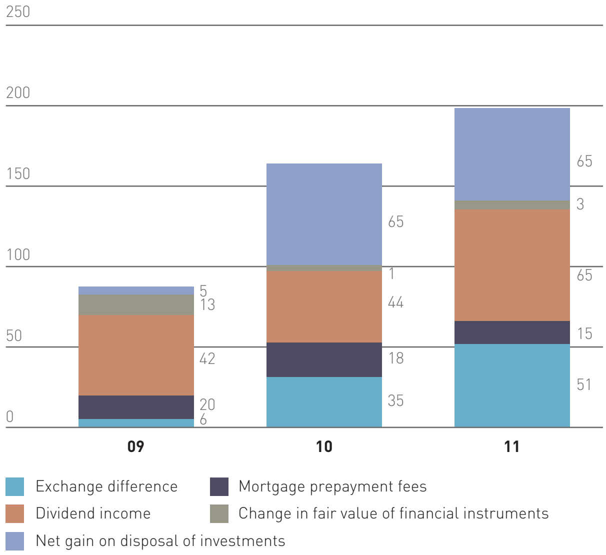

## Other Income

Other income rose 16.5% to HK$198 million in 2011 (2010: HK$170 million) **(Figure 5)**.

The net gain on disposal of investments was about HK$65 million (2010: HK$65 million), which was attributable mainly to re-balancing and diversifying of the investment portfolio.

**Figure 5**

**Major source of other income** (HK$ million)




A dividend income of HK$65 million (2010: HK$44 million) from listed investment securities, equivalent to a dividend yield of about 5%, was received in 2011 (2010: 5%). The income was generated from investments in the ABF Hong Kong Bond Index Fund, ABF Pan Asia Bond Index Fund and a real estate investment trust.

The Corporation recorded an exchange gain of HK$51 million, which was HK$16 million more than that of 2010 (2010: HK$35 million), primarily due to the revaluation of the approved US dollar and renminbi exposure.

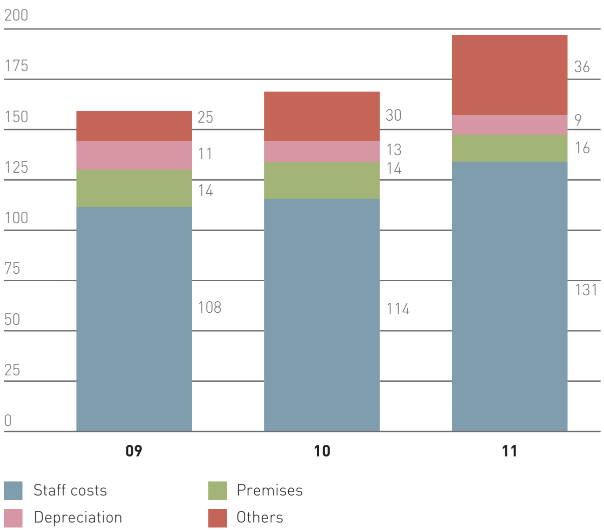
Early prepayment fees were HK$15 million, HK$3 million lower than in 2010 (2010: HK$18 million).

## Operating Expenses

The Corporation continued to maintain stringent cost controls to contain expenses and improve operating efficiency. Operating expenses recorded an 12.3% increase year on year to HK$192 million, but this was HK$40 million lower than that of the approved budget. Staff costs rose by 14.9% to HK$131 million, attributable mainly to further strengthening of risk management capability and the cost of resources required to support the launch of new business initiatives. Staff costs accounted for 68.2% of total operating expenses, compared to 66.7% in 2010. Premises rental and related costs increased by HK$2 million to HK$16 million, attributable mainly to an increase in rental costs. Depreciation charges on assets decreased to HK$9 million (2010: HK$13 million) **(Figure 6)**.

**Figure 6**

**Operating expenses** (HK$ million)

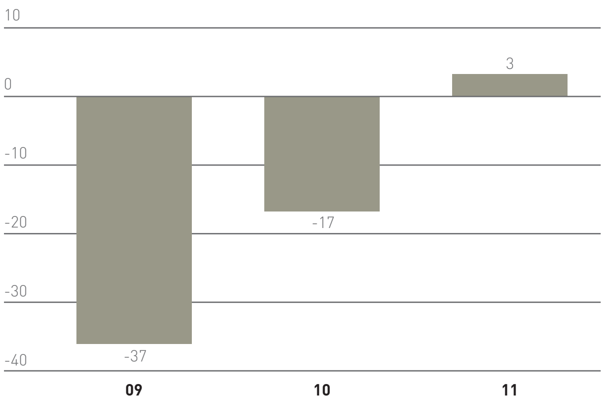



## Allowance for Loan Impairment

Asset quality remained strong, with the delinquency ratio falling from 0.03% to 0.01%. In view of developments in the residential property market and worsening economic conditions, a collective assessment for loan impairment of HK$3 million was charged in 2011, according to the approved prudent provisioning policy **(Figure 7)**.

**Figure 7**

**Provisions / (Write-back) of loan impairment allowances** (HK$ million)




In respect of the overseas mortgage loan portfolio, the asset quality remained healthy as a result of stringent purchasing criteria and prudent risk mitigation. No collective assessment for loan impairment was necessary for 2011 (2010: Nil) and no credit loss was recorded.

Total allowance for loan impairment accounted for 0.02% of the outstanding principal balance (HK$33.1 billion) of the loan portfolio at end of 2011 **(Figure 8)**. During the year, no loans were written off (2010: Nil), and loan recoveries amounted to HK$2 million (2010: HK$5 million).

**Figure 8**

**Ratios**

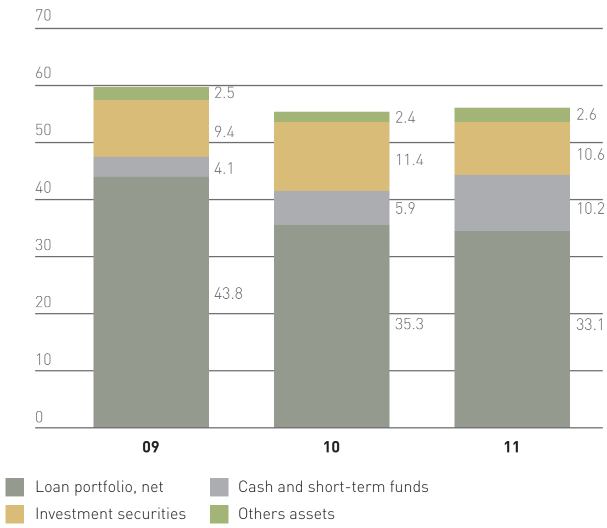
| | 2011 | 2010 |
|---|---|---|
| Delinquency ratio for loan portfolio overdue more than 90 days | 0.01% | 0.03% |
| Total allowance for loan impairment as a percentage of gross loan portfolio | 0.02% | 0.01% |

## Financial Position

Total assets increased by HK$1.5 billion to HK$56.5 billion (2010: HK$55 billion) **(Figure 9)**, due mainly to a HK$4.3 billion increase in cash and short-term funds to HK$10.2 billion as a result of a prudent pre-funding strategy. Surplus cash from mortgage receipts was invested in short-term investment securities to bridge the redemption of matured debt securities issued.

**Figure 9**

**Assets Deployment** (HK$ billion)




## Loan Portfolio

During the year, the Corporation purchased Hong Kong loan assets worth HK$9.7 billion (2010: HK$4.7 billion).

After accounting for prepayments and repayments during the year, the outstanding balance of the Corporation's residential mortgage portfolio and securitised portfolio stood at HK$20.4 billion and HK$0.2 billion, respectively. The Korean residential mortgages recorded a normal runoff of HK$4.7 billion, leaving an outstanding balance of HK$7.2 billion. The commercial mortgage portfolio, which was collateralised by local commercial buildings, remained at the same level of HK$4 billion as that of 2010 **(Figure 10)**.

The average prepayment rate for the loan portfolio (including securitised mortgages) decreased from 24.1% in 2010 to 19.9% in 2011 because of the slowdown in property turnover.

**Figure 10**

**Loan Portfolio, Net**

| | 2011 HK$'000 | 2010 HK$'000 |
|---|---|---|
| Mortgage portfolio | | |
| Residential | | |
| – Hong Kong | 20,402,305 | 18,081,110 |
| – Overseas | 7,239,972 | 11,912,250 |
| Commercial | 4,000,000 | 4,000,000 |
| Securitised portfolio | 169,762 | 717,786 |
| Non-mortgage portfolio | 1,331,401 | 549,820 |
| | 33,143,440 | 35,260,966 |
| Allowance for loan impairment | (7,622) | (2,029) |
| Loan portfolio, net | 33,135,818 | 35,258,937 |

### Investment Securities

The Corporation's investment portfolio comprises mainly bank deposits, short-term commercial paper, certificates of deposit, bonds, yield-based government bond funds and a real estate investment trust. The liquid investment portfolio serves as a liquidity buffer to support the Corporation's business operations, enabling it to respond promptly and smoothly to unforeseen liquidity requirements. The Corporation adopts a prudent, low-risk approach in managing its surplus funds and investment activities in accordance with the approved investment guidelines. As at 31 December 2011, the total investment portfolio decreased slightly from HK$11.4 billion in 2010 to HK$10.6 billion in 2011, which included HK$2.3 billion of available-for-sale investments and HK$8.3 billion of held-to-maturity investments. The decrease in the size of the investment portfolio was attributable to active capital management and a response to the funding needs of loan purchases in 2011. Following the prudent investment guidelines for asset and liability management, the Corporation did not directly or indirectly hold any sub-prime investments, special investment vehicles, collateralized debt obligations, high-risk European sovereign debt, or debt securities issued by failed institutions in its portfolio. In 2011, there was no impairment loss against the investment portfolio.

### Debt Securities Issued

In 2011, the Corporation issued HK$28.5 billion of debt, comprising HK$6.9 billion under the DIP and HK$21.6 billion under the MTN. All the non-HK dollar debt issued under the MTN programme was swapped into HK dollars or US dollars using hedging financial derivatives. As at 31 December 2011, the total outstanding balance of the debt increased by 5.1% or HK$2 billion to HK$41.1 billion as compared with 2010. The increase reflected the Corporation's prudent pre-funding strategy, which was adopted to support its business activities in light of the volatile market conditions. Before taking into account full and partial prepayments, the average life of the loan portfolio was 11 years on a contractual basis. While the Corporation issued debt up to 15 years, 88% of the Corporation's outstanding debt will mature within 5 years.

### Mortgage-backed Securities Issued

During the year, the Corporation did not issue any mortgage-backed securities ("MBS"). In comparison with 2010, the total outstanding balance of the MBS fell by HK$1.1 billion to HK$0.4 billion, reflecting the normal redemption of MBS during the year.

## Off-balance Sheet Exposure

### Mortgage Insurance

The Corporation operates the MIP business on a risk-sharing basis with approved reinsurers. At the end of 2011, the total risk-in-force was about HK$16.6 billion (2010: HK$17.6 billion), of which HK$2.5 billion (2010: HK$2.4 billion) was ceded to approved reinsurers. The off-balance sheet risk-in-force exposure borne by the Corporation decreased slightly by 7.2% to HK$14.1 billion year on year. Of this exposure, the excess loss of HK$3 billion of risk-in-force was hedged through excess-of-loss reinsurance arrangement to reinsure the middle-layer risk positions, while the Corporation retains a portion of the total risk comprising the first-loss and remote risk portions.

The provision for outstanding claims accounted for 0.37% (2010: 0.46%) of the retained risk-in-force at end of 2011. The delinquency ratio remained healthy at 0% (2010: 0.003%).

## Overseas Business

At the end of 2011, the outstanding balance of the Korean mortgage portfolio stood at HK$7.2 billion (2010: HK$11.9 billion). The joint venture in Malaysia, which is engaged in the mortgage-guarantee business, recorded a share of profit of HK$2.8 million (2010: HK$2.3 million). The joint venture in Shenzhen, which is engaged in the mortgage-bridging-guarantee business, generated a small loss of HK$0.5 million (2010: profit of HK$3.3 million). The aggregate profit contribution of the above overseas business in 2011 amounted to HK$81 million (2010: HK$134 million), or 6% of the Corporation's profit before tax.

## Cash Flow Management

The Corporation generated HK$1.4 billion in cash flow from operating activities before changes in operating assets and liabilities. The cash flow was derived mainly from net interest income received. Repayment of the mortgage portfolio was used to finance the redemption of debt securities and loan purchase. Due to the prudent pre-funding strategy adopted to support the Corporation's business activities, net increase in cash equivalent amounted to HK$5.4 billion in 2011 (2010: HK$0.7 billion).

## Capital Management

In October 2011, the Financial Secretary approved the replacement of the Guidelines on Capital-to-Assets Ratio with the Guidelines on Capital Adequacy Ratio, which was largely in reference to the Basel II risk-based capital adequacy framework, for the purpose of enhancing the Corporation's capital management framework.

At the end of 2011, the CAR stood at a healthy level of 19.7%, which was well above the minimum level of 8% stipulated by the Financial Secretary. Under the previous guidelines, the capital-to-assets ratio as at 31 December 2011 was 11.3%.

## Dividend

At the Annual General Meeting held on 30 April 2012, the shareholders having considered the financial performance of the Corporation and the capital requirements for launching new businesses initiatives in 2012, approved a final dividend of HK$0.175 (2010: HK$0.175) per share, totalling HK$350 million (2010: HK$350 million) and representing a dividend payout ratio of 27.9%.