FINANCIAL REVIEW

Given the economic stimulus and liquidity measures by governments and central banks across the globe, the global economy showed clear signs of improvement in the second half of 2009. The HKSAR Government implemented the strategies of "stabilising the financial system, supporting enterprises and preserving employment" in the shortest possible time and provided impetus to the local economy and restored people's confidence. For 2009 as a whole, the economy registered a year-on-year decline of 2.7% in real terms, as compared to a growth of 2.4% in 2008. Underpinned by strong influx of liquidity, the local economy showed a significant upturn later in the year. By the end of 2009, Hang Seng Index rebounded by 52% from the end of 2008 and the local property prices rose nearly 25% from the trough hit in December 2008 on investment demand, recouping all the price correction during the financial crisis. Luxury residential units recorded even larger gains and made record prices since the peak in 1997. The positive wealth effects from the booming asset markets lifted consumer confidence, boosted local spending and improved unemployment. Retail sales have seen a significant rebound in recent months registering an increase of 12.8% in the final quarter as compared to a decline of 3.4% in the first three quarters, reflecting a return of consumer confidence. The unemployment rate steadily came down for four consecutive months, registering 4.9% for the final quarter of 2009.

Income Statement

Financial Performance

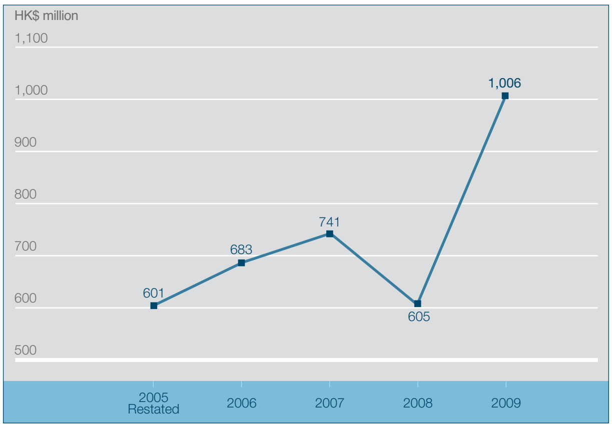
Riding on the strong rebound of the Hong Kong economy and the property market's rally amid the favourable interest rate environment, the Corporation managed to achieve good financial results in 2009. Profits attributable to shareholders amounted to HK$1,006 million in 2009 (Figures 1 and 2), recording a year-on-year growth of 66.3%, which was mainly attributable to the full-year effect of the significant loan purchases made in response to banks' liquidity needs during the global financial crisis, the favourable Prime-HIBOR spread and excellent loan quality.

Operating profit before impairment increased by HK$441 million, or 65.8%, to HK$1,111 million, supported by the key drivers, net interest income that grew 46.2% and other income which rebounded by 127.5%.

Figure 1
Summary of Financial Performance

	2009 HK$ million	2008 HK$ million
Operating profit before impairment	1,111	670
Profit before tax	1,150	634
Profit attributable to shareholders	1,006	605
Return on shareholders' equity	16.2%	10.5%
Return on assets	1.6%	1.1%
Cost-to-income ratio	12.4%	17.5%
Capital-to-assets ratio	9.5%	8.7%

Figure 2
Profit Attributable to Shareholders



The return on shareholders' equity rose to 16.2% (2008: 10.5%), while the return on assets climbed to 1.6% (2008: 1.1%). Although the increased resources to enhance risk management lifted the operating expenses by 11.3%, the significant rise in operating income by 56.3% improved the cost-to-income ratio to 12.4% (2008: 17.5%). The capital-to-assets ratio remained robust at 9.5% (2008: 8.7%), well above the guideline of a minimum at 5% stipulated by the Financial Secretary.

Figure 3
Net Interest Income

	2009 HK$'000	2008 HK$'000
Interest income	1,338,301	1,825,214
Interest expense	(300,594)	(1,115,364)
Net interest income	1,037,707	709,850
Average interest-earning assets	60,017,628	53,515,092
Net interest margin	1.7%	1.3%
Net interest spread on interest-bearing liabilities [1]	1.7%	1.1%

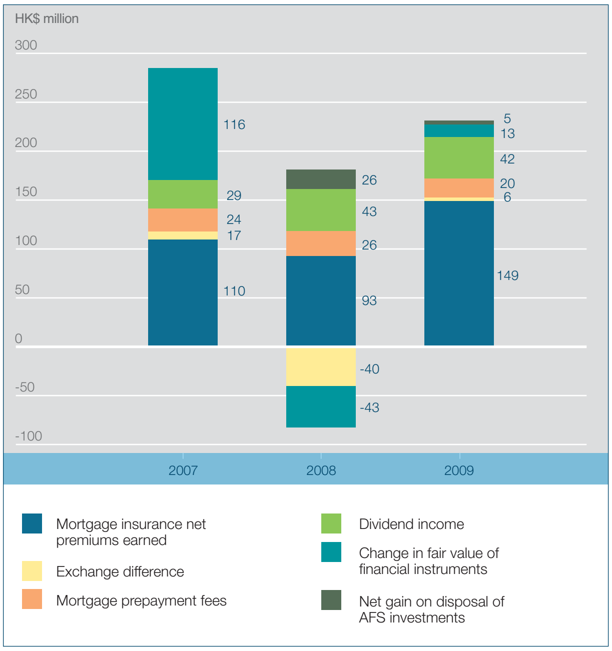
[1] Net interest spread on interest-bearing liabilities = Return on interest-earning assets – Funding cost on interest-bearing liabilities

Average loan portfolio rose by HK$10.5 billion as compared to 2008, following the significant mortgage purchases in late 2008 to provide banking liquidity, which was offset partially by the reduction in cash and available-for-sale investments of HK$4.2 billion and thus resulted in a net increase of HK$6.5 billion average interest earning assets in 2009. This improved the net interest income for the year by 46.2% from HK$710 million to HK$1,038 million (Figure 3). The net interest spread on interest-bearing liabilities rose to 1.7%, compared to 1.1% for 2008, mainly reflecting the favourable Prime-HIBOR spread. Taking into account the shareholders' equity, the net interest margin improved from 1.3% to 1.7%.

Other Income

Other income reported a sharp increase of 127.5% to HK$232 million in 2009 (2008: HK$102 million). The key item was the mortgage insurance premium earned from the MIP (Figure 4).

Figure 4
Major Sources of Other Income



The Corporation operates the MIP business on a risk-sharing basis with approved reinsurers. Whereas the new residential mortgage loans drawn down in the market increased from HK$184.8 billion in 2008 to HK$199.3 billion in 2009, the Corporation's new business underwritten under MIP rose from HK$20.4 billion to HK$36 billion due to the significant improvement in usage rate (in terms of drawdown loan amount against total market mortgage drawdown) from 11% to 18%. The risk-in-force borne by the Corporation grew by 102.9% to HK$11.6 billion in 2009. As a result, the net premiums earned before claims incurred for the year increased by 26.7% from HK$135 million to HK$171 million. After reserving the additional provisions for outstanding claims of HK$22 million, the net premiums earned after provisions increased by 60.2% from HK$93 million to HK$149 million.

Change in fair value of financial instruments recorded a gain of HK$13 million (2008: HK$43 million fair value loss) amid a stable interest rate environment in 2009. Against 2008, the swing in mark-to-market value represented a drop in hedging costs and mark-to-market losses from asset-liability management in 2009.

Dividend income of HK$42 million from listed investment securities equivalent to a dividend yield of about 5% was received in 2009 (2008: HK$43 million), arising from the investments in bond fund and real estate investment trust.

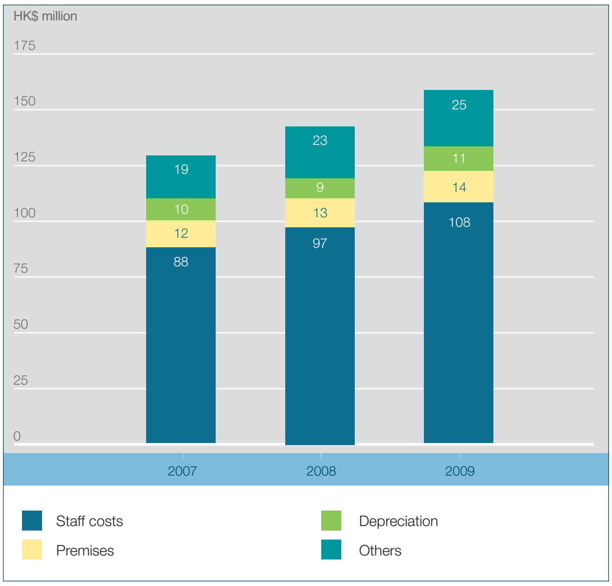
Early prepayment fees were HK$20 million, 23.1% lower than that in 2008 (2008: HK$26 million), reflecting the decrease in mortgage refinancing activities in 2009.

An exchange gain of HK$6 million was recorded as compared to a loss of HK$40 million in 2008, primarily due to the revaluation on US dollar net exposures.

Operating Expenses

The Corporation continued to maintain stringent cost controls and improved operating efficiency. Operating expenses recorded an increase of 11.3% to HK$158 million as compared to 2008, but HK$17 million lower than that of the approved budget. Staff costs rose by 11.3% to HK$108 million, mainly for the establishment of the Risk function and further enhancement of credit risk management capabilities, accounting for 68.6% of the total operating expenses (2008: HK$97 million and 68.5%). Premises rental and the related costs increased slightly by HK$1 million to HK$14 million, mainly attributable to the increase in office area. Depreciation charges on assets increased by 22.2% to HK$11 million (2008: HK$9 million) (Figure 5).

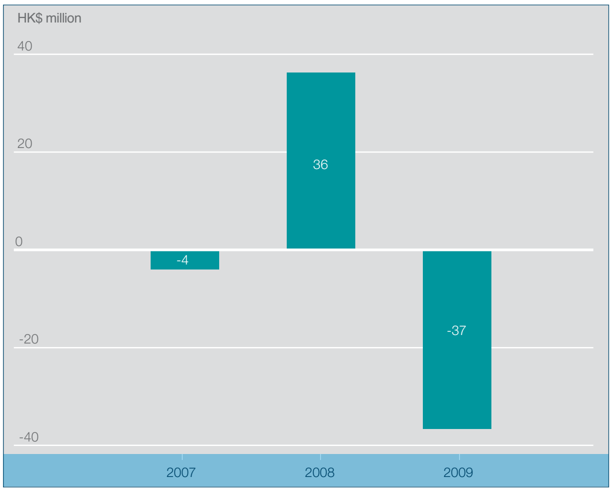
Figure 5
Operating Expenses



Allowance for Loan Impairment

Asset quality remained strong, with the delinquency ratio stayed at 0.04% in 2009, the same level as 2008. Collective assessment for loan impairment of HK$37 million was written back in 2009 (Figure 6) in light of the general rebound of the property market and a reduction of loan portfolio by HK$7 billion to HK$43.8 billion.

Figure 6
(Write-back) / Provisions of Loan Impairment Allowances



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 needed for 2009 (2008: nil).

Total allowance for loan impairment accounted for 0.03% of the outstanding principal balance (HK$43.8 billion) of the loan portfolio as at end-2009, generally similar to the local market level (Figure 7).

Figure 7
Ratios

	2009	2008
Delinquency ratio for loan portfolio overdue for more than 90 days	0.04%	0.04%
Total allowance for loan impairment as a percentage of the gross loan portfolio	0.03%	0.10%

Financial Position Sheet

Total assets fell by HK$5.8 billion to HK$59.8 billion (2008: HK$65.6 billion) (Figure 8), mainly due to the reduction of loan portfolio by HK$7 billion to HK$43.8 billion. Surplus cash from the mortgage receipts was invested in short-term investment securities to bridge the redemption of matured debt securities issued.

Figure 8
Asset Deployment

Loan Portfolio

During the year, the Corporation made a purchase of HK$8.8 billion loan assets (2008: HK$26 billion), including HK$5.7 billion of mortgage assets in Hong Kong and HK$3.1 billion of residential mortgage portfolio in Korea.

At the end of 2009, the outstanding balance of local residential mortgage portfolio and securitised portfolio stood at HK$22 billion and HK$1.3 billion respectively. The outstanding balance of Korean residential mortgages was HK$15.4 billion. The commercial mortgage portfolio, backed by local commercial buildings, was HK$4 billion.

The average prepayment rate of the loan portfolio (including securitised mortgages) increased from 13.8% in 2008 to 16.3% for 2009. Mainly due to the normal run-off and competitive refinancing activities in the local mortgage market, the loan portfolio recorded a net reduction by HK$7 billion to HK$43.8 billion (Figure 9).

A significant improvement in the property market price saw loan impairment provisions fall by HK$37 million to HK$14 million. During the year, the loans written off amounted to HK$3 million (2008: HK$4 million), which were offset by the recovery of HK$3 million of loans previously written off (2008: HK$5 million).

Figure 9
Loan Portfolio, Net

	2009 HK$'000	2008 HK$'000
Mortgage portfolio Residential		
– Hong Kong	21,980,141	27,624,099
– Overseas	15,441,285	15,905,032
Commercial	4,000,000	4,000,000
Securitised portfolio	1,314,685	1,878,761
Non-mortgage portfolio	1,066,616	1,402,756
	43,802,727	50,810,648
Allowance for loan impairment	(14,011)	(50,536)
Loan portfolio, net	43,788,716	50,760,112

Investment Securities

The Corporation adopts a prudent and low-risk approach in managing its surplus funds and investment activities in accordance with the approved investment guidelines. The Corporation's investment portfolio is mainly made up of bank deposits, short-term commercial paper, certificates of deposit, bonds, yield-based government bond funds and real estate investment trust. The liquid investment portfolio serves as a buffer to support the Corporation's business operations, enabling it to respond quickly and smoothly to unforeseen liquidity requirements. As at 31 December 2009, the total investment portfolio stood at HK$9.4 billion which included HK$3.6 billion of available-for-sale investments and HK$5.8 billion of held-to-maturity investments. The increase in investment portfolio from HK$7.7 billion in 2008 was due to the active pre-funding activities in 2009, in contrast with the contraction in 2008 to meet funding needs following the outbreak of financial crisis. With the prudent investment guidelines and asset and liability management, the Corporation did not directly or indirectly hold any sub-prime investment, special investment vehicles, collateralised debt obligations or debt securities issued by the failed financial institutions in its portfolios. There were no impairment losses or provisions against the investment portfolio in 2009 (2008: nil).

Debt Securities Issued

The Corporation issued a total of HK$22.7 billion of debts in 2009, comprising HK$15.5 billion debts under the DIP and HK$7.2 billion under the MTN. All non-Hong Kong dollar debts issued under MTN were swapped into Hong Kong dollar or US dollar liabilities. As at 31 December 2009, the total outstanding balance of debts issued rose slightly by 4% or HK$1.7 billion to HK$44.5 billion as compared with 2008. The rise reflected the net increase after redemption of HK$19.6 billion debts matured in 2009 and the change in fair value of debt securities issued. Without taking into account the expected full and partial prepayments, the average life of the loan portfolio at the end of 2009 was nine years on a contractual basis while 86.7% of the Corporation's outstanding debts would mature within five years, given that the Corporation has issued debts with tenors from one month to 15 years.

Mortgage-Backed Securities Issued

During the year, the Corporation did not issue any MBS. As at 31 December 2009, the total outstanding balance of the MBS issued dropped by 37.5% or HK$1.2 billion to HK$2 billion from 2008, reflecting the redemption of MBS in 2009.

Advance from the Exchange Fund

The Corporation has a HK$30 billion Revolving Credit Facility from the Exchange Fund as back-up liquidity. During the year, the Corporation repaid all outstanding advances (HK$8 billion from 2008) under the facility.

Overseas Businesses

The Corporation acquired HK$3.1 billion of Korean mortgage portfolio in 2009, and the outstanding balance stood at HK$15.4 billion by year end.

The Corporation has joint ventures in Malaysia (50% owned) and in Shenzhen, China, (90% owned) with an investment of HK$121 million and HK$102 million respectively, together representing 0.4% of the Corporation's total assets. The jont venture in Malaysia engages in mortgage guarantee business and recorded a share of profit of HK$1.9 million in 2009 as compared to a loss of HK$8,000 in 2008. The joint venture in Shenzhen started its bridging mortgage guarantee business in late 2009 and incurred a loss of HK$4.3 million mainly due to the initial set-up cost. The aggregate profit contribution from the overseas businesses amounted to HK$126 million (2008: HK$52 million), or 11% of the Corporation's profit before tax in 2009.

Cash Flow Management

In 2009, the Corporation generated HK$1.2 billion (HK$0.6 billion in 2008) of cash flows from operating activities before changes in operating assets and liabilities, derived mainly from net interest income received. Repayment on mortgage portfolio was used to finance debt securities redemption and invest in short-term available-for-sale investment portfolio. Net increase in cash amounted to HK$1.1 billion in 2009, which compared favourably to HK$338 million in 2008.

Capital Management

The Financial Secretary has approved the following capital adequacy framework to account for different levels of risk embedded in the financial products under the MPP, the two MBS Programmes, non-residential mortgage loans, non-mortgage loans and the MIP (Figure 10).

Figure 10

Product	Minimum Capital-to-Assets Ratio
Mortgage Purchase Programme (i) regular mortgage loans	5% of regular mortgage loan portfolio (based on outstanding principal balance or committed amount plus accrued interest)
(ii) loans originated under the Home Starter Loan Scheme (HSLS) and Sandwich Class Housing Loan Scheme (SCHLS)	2% of HSLS and SCHLS loans (based on outstanding principal balance or committed amount plus accrued interest)
Mortgage-Backed Securities (MBS)	2% of MBS portfolio(based on outstanding principal balance plus accrued interest)
Securitised mortgage loans transferred from the Corporation to the special purpose entities (SPE) that are qualified for derecognition from the Corporation's balance sheet before account consolidation of the SPE	0% of securitised mortgage loans
Securitised mortgage loans transferred from the Corporation to the SPE that are not qualified for derecognition from the Corporation's balance sheet before account consolidation of the SPE, where the mortgage-backed securities issued are: (i) guaranteed by the Corporation	2% of securitised mortgage loans
(ii) not guaranteed by the Corporation	5% of securitised mortgage loans
Non-residential mortgage loans	8% of the non-residential mortgage loan portfolio
Non-mortgage loans	8% of the non-mortgage loan portfolio
Overseas residential mortgage loans	The capital requirement applicable to the jurisdiction in which the overseas residential property is situated to adjust for the 5% requirement on regular mortgage loan portfolio
Mortgage Insurance Programme	0% of risk-in-force value of exposure covered by the reinsurance arrangement with Approved Reinsurers 5% of risk-in-force value of exposure not covered by the reinsurance arrangement

The capital base, defined as shareholders' equity excluding hedging reserve plus the allowance for loan impairment under collective assessment, grew by 12.5% from HK$5.6 billion in 2008 to HK$6.3 billion in 2009 amid the earnings growth. At the end of 2009, the aggregate amount of the Corporation's on-balance sheet assets and off-balance sheet exposure was HK$66.2 billion, which mainly consisted of HK$35.2 billion of risk-weighted mortgage loans, HK$1.7 billion of hire purchase assets, HK$9.4 billion of investment securities, HK$4.1 billion of cash and bank balances, HK$11.6 billion of risk-weighted mortgage insurance exposure, HK$2.8 billion of replacement costs and potential future credit exposures of derivative contracts, HK$0.3 billion of risk-weighted guarantee exposure under the MBS programmes and HK$1.1 billion of other assets. The CAR stood at a healthy level of 9.5%, well above the minimum level of 5% stipulated by the Financial Secretary (2008: 8.7%).

Dividend

At the Annual General Meeting held on 20 April 2010 Shareholders, having considered the exceptional financial performance of the Corporation in 2009, approved a final dividend of HK$0.25 (2008: HK$0.125) per share, totalling HK$500 million (2008: HK$250 million), representing 49.7% of the profit after tax.