Despite the once-in-a-century financial crisis, the Corporation was able to achieve another year of solid financial results. The Corporation has proven to be highly efficient and resilient, carrying out its important policy role of helping to maintain banking and financial stability by purchasing loan assets from local banks. The HKMC Group recorded a profit after tax of HK$605 million, only 18% lower than the record set in 2007.

FINANCIAL REVIEW

Income Statement

Financial Performance

The growth of the Hong Kong economy slowed remarkably in the second half of 2008, as the external sector slackened amid the outbreak of the global financial crisis causing significant asset de-leveraging and further credit tightening. A series of unprecedented economic stimulus packages and measures undertaken by various governments and central banks to counter the increasing risk of global recession have lowered the market interest rates, but signs of returning stability and easing of credit crunch were yet to be seen.

While the local stock market was entangled in the full-blown global financial crisis, domestic demand suffered greatly and consumer spending turned more cautious in the wake of highly uncertain global financial and economic environment. Along with the economic slowdown, the unemployment rate bottomed out at 3.2% in May to July and edged up to 4.1% in the last quarter of 2008. However, the local property price adjustment seemed to be just beginning. Residential property price was declined notably since September and secondary housing turnover shrank to a very low level in the 4th quarter, though in general the property market appeared to be relatively resilient as the general affordability and leverage were healthier than a decade ago.

In the midst of deepening financial crisis and uncertain economic environment, the HKMC Group achieved a profit after tax of HK$605 million in 2008 (Figures 1 and 2), 18.3% below that of 2007, attributable by an increase in loan provisioning and a swing of fair value changes that offset the rebound of net interest income. The Corporation has maintained its strong commitment to risk management in pursing its business diversification in Hong Kong and overseas, and has not purchased any sub-prime mortgages or invested in sub-prime related products. The asset quality of the loan portfolio and MIP business, which are subject to the stringent loan purchasing and underwriting criteria, both remained at a healthy level. Upheld by the prudent investment guidelines and asset and liability management, the asset quality of the investment portfolio remained resilient in this full-blown credit crunch and risk migration. No impairment in respect of investment portfolio was required.

Operating profit before impairment decreased by HK$147 million, or 17.9% to HK$670 million. The significant decrease in other income by 65.6% and the increase of 9.9% in operating expenses outweighed the 9.3% improvement in net interest income.

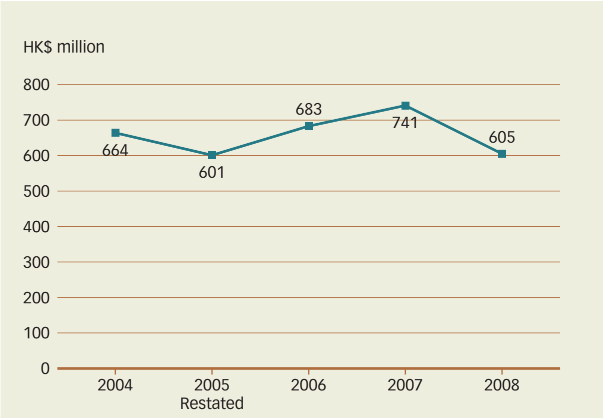
FIGURE 1

Summary of financial performance

	2008 HK$ million	2007 HK$ million
Operating profit before impairment	670	817
Profit before tax	634	821
Profit after tax	605	741
Return on shareholders' equity	10.5%	13.7%
Return on assets	1.1%	1.6%
Cost-to-income ratio	17.5%	13.6%
Capital-to-assets ratio	8.7%	11.2%

FIGURE 2

Profit after tax



The return on shareholders' equity remained strong at 10.5% (2007: 13.7%), while the return on assets slid to 1.1% due to the pre-funding strategies resulting in a general expansion of balance sheet in 2008 (2007: 1.6%). The increase in staffing to enhance risk management lifted up the operating expenses by 9.9%, combined with a fall in operating income by 14.2%, leading to the increase in the cost-to-income ratio to 17.5% (2007: 13.6%). The capital-to-assets ratio maintained at 8.7% (2007: 11.2%), well above the guideline of a minimum of 5% stipulated by the Financial Secretary.

The significant increase in the loan portfolio by HK$16.3 billion has attributed to an increase in the average interest earning assets in 2008, which improved the net interest income for the year by 9.3% from HK$649 million to HK$710 million (Figure 3). The net interest spread was maintained at 1.1%, compared to 1% for 2007. Taking into account the shareholders' equity, the net interest margin remained healthy at 1.3%.

Other Income

Other income reported a fall of 65.6% to HK$102 million in 2008 (2007: HK$296 million). The reduction was underpinned mainly by a swing of change in fair value on hedging financial instruments and revaluation loss of US dollar net exposures, which were partially offset by the increase in dividend income from the investment portfolio, and net gain on disposal of available-for-sale investment securities. (Figure 4)

Change in fair value of financial instruments recorded a loss of HK$43 million in 2008 as compared to a gain of HK$116 million in 2007, mainly attributable to the mark-to-market loss on hedging instruments and increase in hedging costs amid volatile interest rates environment. The hedging operations had contributed substantially to the net interest income during the period but were not sufficient to offset the mark-to-market loss. The hedging instruments were derivatives (principally interest rate swaps and foreign exchange contracts), used for hedging purposes in the management of the Corporation's assets and liability portfolios to mitigate the interest rate volatilities and shrinkage of net interest income. After a series of rate cuts and quantitative easing adopted by central banks in the second half of 2008, the interest rate volatility has been reduced significantly and would stabilize the change in fair value of the hedging financial instruments.

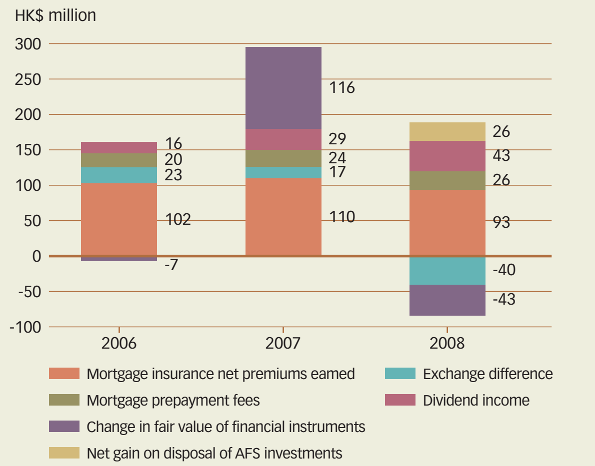
Dividend income of HK$43 million from listed investment securities equivalent to a dividend yield of about 5% was received in 2008, 47.2% or HK$14 million higher than 2007 (2007: HK$29 million), mainly due to the increase in investments in bond fund and real estate investment trust.

FIGURE 3
Net interest income

	2008 HK$'000	2007 HK$'000
Interest income	1,825,214	2,339,433
Interest expense	(1,115,364)	(1,690,101)
Net interest income	709,850	649,332
Average interest-earning assets	53,515,092	44,005,195
Net interest margin	1.3%	1.5%
Net interest spread on interest-bearing liabilities [1]	1.1%	1.0%

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

FIGURE 4
Major source of other income



The Corporation operates the MIP business on a risk-sharing basis with approved reinsurers. With the increase in new residential mortgage loans drawn down in the market from HK$173.5 billion in 2007 to HK$184.8 billion in 2008, our new business underwritten under MIP rose from HK$13.2 billion to HK$20.4 billion amid a significant improvement in market penetration rate from 12% to 16%. The risk-in-force borne by the Corporation grew by 62.6% to HK$5.7 billion in 2008. As a result, the net premiums earned before claims incurred for the year increased by 22.5% from HK$110 million to HK$135 million. After reserving the provisions for outstanding claims of HK$41 million, the net premiums earned after provisions decreased by 14.8% from HK$110 million to HK$93 million.

Early prepayment fees were HK$26 million, or 10.3% or HK$2 million higher than 2007 (2007: HK$24 million), reflecting the increase in mortgage refinancing activities in the first half of 2008.

An exchange loss of HK$40 million was recorded as compared to a gain of HK$17 million in 2007, primarily due to the revaluation on US dollar net exposures.

Operating Expenses

The Corporation continued to maintain stringent cost controls to contain expenses while seeking to expand the scope of business. Operating expenses recorded an increase by 9.9% to HK$142 million as compared to 2007. Staff costs rose by 10% to HK$97 million, for expansion of risk management functions, accounted for 68.5% of total operating expenses (2007: HK$88 million and 68.4%). Premises rental and the related costs increased slightly by HK$1 million to HK$13 million, mainly attributable to the increase in rates on the rise of rateable value of existing office premises. Depreciation charges on assets fell by 11.9% to HK$9 million (2007: HK$10 million). (Figure 5)

Allowance for Loan Impairment

Asset quality remained strong, with the delinquency ratio falling from 0.09% to 0.04%. Collective assessment for loan impairment of HK$36 million was charged to the income statement of 2008 to provide for the credit migration risk in light of the rising unemployment rate and decline in property prices as a result of the outbreak of financial crisis, as compared to the release of HK$4 million in 2007. (Figure 6)

In respect of the mortgage loan portfolio in Korea, 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 2008 (2007: nil).

Total allowance for loan impairment accounted for 0.1% of the outstanding principal balance (HK$50.8 billion) of the loan portfolio as at end-2008. (Figure 7)

Balance Sheet

Total assets rose by HK$17 billion to HK$65.6 billion (2007: HK$48.6 billion), mainly due to the surge in loan portfolio by HK$16.3 billion to HK$50.8 billion and the reduction in investment securities portfolio from HK$9.5 billion to HK$7.7 billion (Figure 8)

Loan Portfolio

The Corporation achieved a record purchase of HK$26 billion loan assets in 2008 (2007: HK$9.6 billion), including HK$13.6 billion residential mortgage loans and HK$0.2 billion hire purchase assets in Hong Kong; and HK$12.2 billion of residential mortgage portfolio in Korea. Following the prolonged global financial crisis and tightened liquidity in the local banking sector, the Corporation made a significant purchase of loans assets in Hong Kong to fulfil its core policy role to address the liquidity needs as well as balance sheet

FIGURE 5

Operating expenses

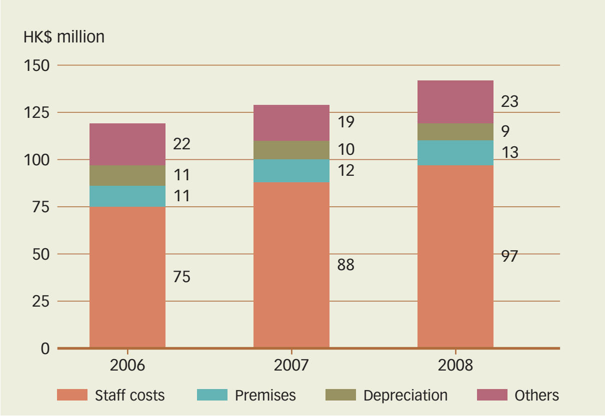


FIGURE 6

Provisions/(Write-back) of loan impairment allowances

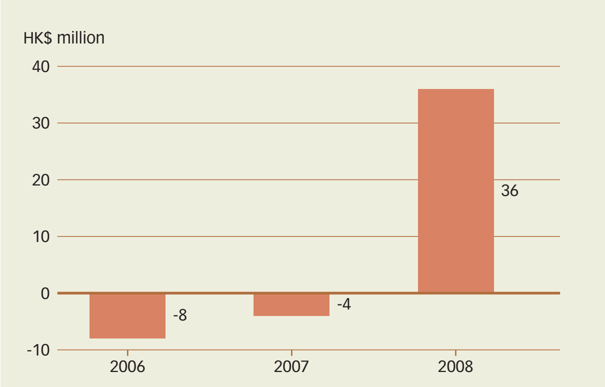


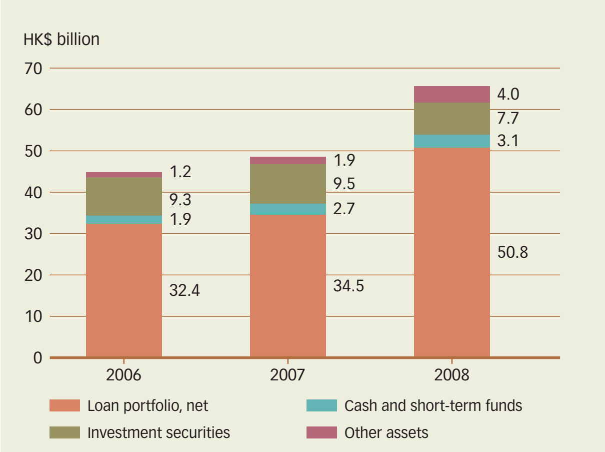
FIGURE 7

Ratios

	2008	2007
Delinquency ratio for loan portfolio overdue for more than 90 days	0.04%	0.09%
Total allowance for loan impairment as a percentage of the gross loan portfolio	0.10%	0.04%

FIGURE 8

Asset Deployment



management of the local banking sector. Amid the distorted debt capital market, the purchase was partially funded by active pre-funding and the advance drawn under the revolving credit facility provided by the Exchange Fund.

As approved by the Board in 2006 as one of the strategic moves to seek developing new business in overseas markets, the Corporation made further overseas mortgage acquisition of HK$12.2 billion equivalent of Korean residential mortgages portfolio in the form of mortgage-backed securities in 2008. The income contribution from overseas residential mortgages to profit after tax was HK$75 million for 2008.

After accounting for the prepayment and repayment during the year, the outstanding balance of residential mortgage portfolio and securitised portfolio, being the residential mortgages situated in Hong Kong, stood at HK$27.6 billion and HK$1.9 billion respectively. The outstanding balance of Korean residential mortgages was HK$15.9 billion. For commercial mortgage portfolio, which was backed by local commercial buildings, maintained at the same level as 2007 at HK$4 billion at the end of 2008.

The average prepayment rate of the loan portfolio (including those securitised mortgages) increased from 13.7% in 2007 to 13.8% for 2008. Taking into account of the normal run-off of the loan portfolio and the significant loan purchases in 2008, the loan portfolio recorded a net increase by HK$16.3 billion to HK$50.8 billion. (Figure 9)

FIGURE 9
Loan Portfolio, Net

	2008 HK$'000	2007 HK$'000
Mortgage portfolio		
Residential		
– Hong Kong	**27,624,099**	20,413,884
– Overseas	**15,905,032**	5,458,180
Commercial	**4,000,000**	4,000,000
Securitised portfolio	**1,878,761**	2,796,551
Non-mortgage portfolio	**1,402,756**	1,805,606
	50,810,648	34,474,221
Allowance for loan impairment	**(50,536)**	(13,930)
Loan portfolio, net	**50,760,112**	34,460,291

Investment Securities

The Corporation's investment portfolio is mainly made up of bank deposits, short-term commercial papers, certificates of deposit, bonds, yield-based government bond funds and real estate investment trust. The liquid investment portfolio serves as a liquidity buffer to support the Corporation's business operations, enabling it to respond quickly and smoothly to unforeseen liquidity requirements. The Corporation adopts a prudent and low-risk approach in managing its surplus funds and investment activities in accordance with the approved investment guidelines. As at 31 December 2008, the total investment portfolio decreased from HK$9.5 billion in 2007 to HK$7.7 billion which included HK$2.1 billion of available-for-sale investments and HK$5.6 billion of held-to-maturity investments. The decrease in investment portfolio was in response to the funding needs of the significant mortgage purchases in 2008. 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, collateralized debt obligations or debt securities issued by the failed financial institutions in its portfolios. No impairment of assets was required.

Debt Securities Issued

The Corporation issued a record total of HK$24.4 billion of debts in 2008, comprising HK$19.2 billion debts under the DIP, HK$4.7 billion equivalent of non-HK dollar debts including Australian dollar, Singapore dollar, Japanese Yen and US dollar debts under the MTN and HK$0.5 billion retail bonds under the RBIP. All the non-HK dollar debts were swapped into HK dollars liability using hedging financial derivatives. As at 31 December 2008, the total outstanding balance of the debts issued rose by 28.5% or HK$9.5 billion to HK$42.8 billion as compared with 2007. The rise reflected the net increase after redemption of HK$16.5 billion debts matured in 2008 and the resulting change in fair value of debt securities issued. Before taking into account of full and partial prepayments, the average life of the loan portfolio was 9 years on a contractual basis while the Corporation issues debts from 1-month to 15-year horizon, 84.1% of Corporation's outstanding debts would mature in the range of 1 to 5 years.

Mortgage-backed Securities Issued

During the year, both of the special purpose entities did not issue any mortgage-backed securities. As at 31 December 2008, the total outstanding balance of the mortgage-backed securities issued decreased by 23.7% or HK$1 billion to HK$3.2 billion compared with 2007. The decrease in outstanding balance of mortgage-backed securities issued purely reflected the redemption of mortgage-backed securities in 2008.

Advance from the Exchange Fund

The Exchange Fund through the HKMA has provided the Corporation with a HK$30 billion revolving credit facility as a back-up liquidity for the Corporation to fulfil its objective of better contributing to the banking stability. At the end of 2008, the Corporation had drawn HK$8 billion under the revolving credit facility to partially fund the acquisition of Hong Kong residential mortgages assets from local banks amid the distorted debt capital market.

Capital Management

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

The capital base, defined as shareholders' equity excluding hedging reserve plus the allowance for loan impairment under collective assessment, grew by 4.5% from HK$5.4 billion to HK$5.6 billion in 2008. At the end of 2008, the aggregate amount of Corporation's on-balance sheet assets and off-balance sheet exposure was HK$64.9 billion, which mainly consisted of HK$40.2 billion and HK$2.2 billion of risk-weighted mortgage loans and hire purchase assets respectively, HK$7.7 billion investment securities, HK$3.1 billion of cash and bank balances, HK$5.7 billion risk-weighted mortgage insurance exposure, HK$3.9 billion of replacement costs and potential future credit exposures of derivative contracts, HK$0.4 billion risk-weighted guarantee exposure under the MBS programmes and HK$1.7 billion other assets. The capital-to-assets ratio ("CAR") stood well above the minimum level of 5% stipulated by the Financial Secretary, at a healthy level of 8.7% (2007: 11.2%).

Dividend

At the Annual General Meeting held on 16 April 2009, Shareholders approved a final dividend of HK$0.125 (2007: HK$0.125) per share, totalling HK$250 million, representing a 41.3% of the profit after tax.

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)
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
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