

**The Administration's response:****HKMC's Business Development**

The HKMC was established in 1997 under the Companies Ordinance, with the objectives of maintaining financial stability, promoting homeownership and developing the debt market in Hong Kong. The central focus of the HKMC's business activities is to create value for participants in the Hong Kong mortgage and debt markets through an effective application of its unique intermediary role.

2. Under its asset purchase programme, the HKMC has purchased a total of HK\$124 billion of mortgages thereby helping:

- (a) authorized institutions to manage their liquidity and credit risks, particularly during the financial crises; and
- (b) the Housing Authority and Housing Society in replenishing funds for their housing programmes.

3. Under the Mortgage Insurance Programme ('MIP') launched in 1999, banks have originated HK\$ 115 billion of insured mortgage loans. The portion above 70% loan-to-value ("LTV") ratio amounted to HK\$ 27 billion. The MIP has served to:

- (a) assist some 59,000 households to buy their own homes;
- (b) enable banks to lend beyond 70% LTV ratio without incurring additional risk; and
- (c) diversify part of the risk overseas through reinsurance arrangements.

4. The HKMC has also promoted development of the bond market by increasing:

- (a) its depth with regular issuance (HK\$154 billion of debt and MBS issued since inception), and

- (b) its width with new products including the retail bonds introduced in 2001.

5. The HKMC's business diversification beyond Hong Kong has been pursued following a strategic business development review conducted in 2006 by a management consultant. The Board accepted the consultant's recommendation that it is important for the Corporation to maintain its capability and readiness to discharge its core policy role as liquidity provider to the Hong Kong's banking system, especially during times of financial stress. The business diversification is intended to strengthen the HKMC's financial position and hence its ability in executing its policy objectives in Hong Kong for the benefit of the local financial community as a whole. In the same year, the Exchange Fund Advisory Committee endorsed an extension of the purpose of the capital injection to the HKMC to include section 3(2) of the Exchange Fund Ordinance which provides of the use of the Exchange Fund for investment purposes, in addition to section 3(1A) for purpose of maintaining the stability and integrity of the monetary and financial systems of Hong Kong.

6. The HKMC's overseas activities are often undertaken in collaboration with the relevant central banks. For example, the mortgage guarantee businesses in Malaysia and Shenzhen are in the form of a joint venture with a company wholly or partly owned by Bank Negara Malaysia and the Shenzhen Branch of the People's Bank of China respectively. These central banks consider the HKMC's business model to be an effective way to address risks related to mortgages and its general adoption to be a way to improve regional financial stability. The joint venture in Malaysia also provides a platform for the HKMC to benefit from the Islamic financial market development expertise of its partner, Cagamas (Malaysia's national mortgage corporation). This helps deepen the HKMC's understanding of shariah-compliant mortgage-related businesses and equip the HKMC to develop such Islamic business in the future.

7. As regards the purchase of mortgage assets overseas, the HKMC adopts a risk-averse approach to mitigate credit risk through prudent seasoning and LTV ratio requirements, and credit enhancement measures provided by the seller to absorb potential credit losses. The foreign exchange risk has been fully hedged to protect the Corporation against adverse movements in exchange rates. There has been no loss incurred in the Corporation's overseas mortgage purchases.

8. In terms of local diversification, the purchase of taxi loans from authorized institutions is intended to help banks better manage the liquidity and credit risks of their asset portfolio by enlarging the category of assets that can be sold to the HKMC in case of need.

9. All the above diversification measures have been conducted after approval by the Board of Directors of the Corporation. The HKMC Board has a broad representation from the public and private sectors, including a number of Legislative Council members and the Chairman of the Consumer Council.

10. The Revolving Credit Facility extended by the Exchange Fund to the HKMC is not intended to be used as a normal funding source on a day-to-day basis. It is mainly intended to help the HKMC to execute its function of providing liquidity to banks under abnormal market situations. In order to achieve this effect, the interest rate of the facility is deliberately set at a level that is above the HKMC's average cost of funds under normal market conditions. As regards whether the HKMC is engaged in unfair competition to the detriment of commercial entities conducting similar financing business in Hong Kong, we have been advised that this matter falls outside the scope of the World Trade Organization's Agreement on Subsidies and Countervailing Measures and the question of a breach by the HKMC does not arise.

11. To summarise, the HKMC adopts a market-oriented approach in fulfilling its core objectives. It aims at creating additional value rather than entering into direct competition with other market players. The HKMC's Memorandum and Articles of Association deliberately preclude the Corporation's entering into mortgage origination and instead acting as a passive buyer of assets from banks. Through the MIP, it has enlarged banks' mortgage lending capacity and created a new market for the local insurance industry. The standard platforms established for issuance of retail bonds and MBS have been widely accepted by other potential issuers. The operation of the HKMC therefore does not run counter to the concept of "Small Government, Big Market".

## Investment strategy

12. The HKMC follows a prudent and low-risk investment approach in investing surplus funds (HK\$7 billion at end-May 2009, arising from mortgage prepayments and pre-funding activities) in accordance with the Investment Guidelines approved by the Board. The investment portfolio consists of high quality and liquid securities and does not have any exposure to US sub-prime mortgage related securities, collateralised debt obligations or debt securities issued by the failed financial institutions.

13. As a rated entity, the HKMC is subject to close monitoring by the international credit rating agencies. Both Moody's and S&P have very high regard for the HKMC's risk management framework which underpin the strong credit ratings that they assigned to the Corporation. In addition, the HKMC engaged a reputable external consultant to conduct an independent assessment of its risk management framework in December 2008. The results were very satisfactory and the consultant commented that "the HKMC has diverse and robust measures in place to drive insights on credit risks and interest rate risks, complemented by reliable risk systems and reports" and "top management demonstrates strong commitment to prudent risk management". At the recommendation of the consultant, risk management has been further enhanced at the Corporation with the appointment of a Chief Risk Officer (at the rank of Senior Vice President) to strengthen enterprise level risk monitoring and oversight.

14. The HKMC has been a profitable organisation since its first full year of operation in 1998. Over the past 11 years, the average return on equity was 11.6%. This has been achieved through highly effective and stringent risk management in the Corporation's business activities. In the area of asset acquisition, the delinquency ratio is at a low of 0.04% at end-March 2009. As regard mortgage insurance, the delinquency ratio is 0.03% at end-March 2009.

## Remuneration of the HKMC staff

15. The remuneration for HKMC staff members has two components: (a) monthly base salary and (b) an annual discretionary performance-based bonus. The remuneration review is determined each year by the Board of

Directors, with reference to market data obtained from the pay trend survey conducted by two human resources consultant firms:

- (a) Base salary adjustment: it is based on the average of the median of the pay adjustment of banks and financial market institutions covered in the market data survey; and
- (b) Performance-based Bonus Scheme: it takes into account the market bonus payout level and the relative performance of the HKMC against that of locally incorporated banks, as measured by the median Return on Equity (“ROE”).

16. When the Board evaluates the financial performance of the Corporation, it also considers whether the Corporation took excessive risks in achieving the financial performance.

17. Staff will be awarded base salary adjustment and bonus on the basis of the parameters below:

- (a) individual performance ratings;
- (b) competitiveness of pay package against market median; and
- (c) turnover rate in the rank and staff retention considerations.

18. According to the pay trend survey, the positioning of the HKMC remuneration package (base salary plus bonus) is at or below market median for all ranks of staff.