Paper for Financial Affairs Panel
Meeting on 2 November 2009

The Role and Operation of the
Hong Kong Mortgage Corporation Limited ("HKMC")

I. Core Role of the HKMC

1 The HKMC was established in 1997 by the Hong Kong Monetary Authority with capital provided by the Exchange Fund.

<u>Aid banking and financial stability through provision of liquidity to banks</u>

2 The HKMC provides liquidity to banks by purchasing assets from banks on an arm's-length, commercial basis, and with no stigma attached. Such liquidity role is especially prominent in crisis time – HK$11.4 billion of mortgage loans was purchased in 1998 after the Asian Financial Crisis.

3 In late 2008, after the collapse of Lehman Brothers, banks offered around HK$30 billion of mortgage loans for sale. In the end, due to improvement in market conditions, the HKMC purchased HK$11.5 billion of mortgage loans, about 2% of the outstanding mortgage loans (HK$588 billion) in Hong Kong.

4 This scale of purchase is nearly four times higher than the HKMC's average annual purchase of HK$2.4 billion of assets from banks during non-crisis times.

<u>Promoting homeownership through the Mortgage Insurance Programme ("MIP")</u>

5 The HKMC pioneered mortgage insurance in Hong Kong in 1999. Up to end-September 2009, more than 65,600 families have been able to enjoy homeownership with the help of MIP, with total loan amount of HK$132 billion. The average loan size is around HK$ 2 million, indicating that the programme is of particular value to first-time home buyers. The MIP usage rate rose from 3.1% in 1999 to 18.7% for January to August 2009.

<u>Stringent underwriting standards</u>

6 The HKMC's retained loan portfolio has a combined delinquency plus rescheduled loan ratio of 0.15% as at July 2009, lower than the market level of 0.18%.

7 The over 90-day delinquency ratio of the MIP stood at 0.03% at end-August 2009, compared to the industry average of 0.05%.

8 The HKMC's stringent underwriting standards serve as benchmark for banks in Hong Kong.

Debt Issuance promotes but does not crowd out market

9 The HKMC has HK$34.3 billion in outstanding debt that accounts for only 4% of total outstanding HKD debt of HK$862 billion. The HKMC also has outstanding foreign currency debt issuance equivalent to HK$5.2 billion.

10 Hong Kong's debt market as a proportion of GDP is under 60%, which compares with over 150 to 200% for the developed countries and around 100% for Singapore, Korea and Malaysia. The local debt market needs more quality issuers and product diversification. Crowding out is therefore not an issue at all. The HKMC has also helped promoting the debt market by pioneering the retail bond issuance mechanism and the standardisation of mortgage and MBS documentation.

II Comparison with Fannie Mae / Freddie Mac

11 While the HKMC was initially set up with reference to the business model of Fannie Mae and Freddie Mac (Fannie/Freddie), the HKMC has a much more prudent risk management framework:

(a) primary mission – the HKMC adopts a passive approach in making purchases from banks to promote banking stability whereas Fannie/Freddie purchase mortgages through an "originate-and-sell" model for profit maximisation and promoting homeownership;

(b) leverage – Fannie/Freddie had 60 to 80 times at end-2007 but it is only 8 to 10 times for the HKMC;

(c) delinquency ratio – 0.08% for the HKMC's retained loan portfolio at end July 2009, in contrast with Fannie's 4.2% and Freddie's 3%; and

(d) capital risk weight for MBS – 2% for the HKMC versus 0.45% for Fannie/Freddie.

III. Overseas Business Diversification

12 The HKMC diversifies overseas in some cases for commercial reasons and in some cases also in the context of regional central bank cooperation.

Acquisition in Korea

13 The HKMC's mortgage purchases in Korea provide useful diversification in order to maintain a steady flow of mortgage purchase.

14 Korean purchases represent prudent and profitable investment as per section 3(2) of the Exchange Fund Ordinance because the HKMC's capital from the Exchange Fund is also for investment purposes since 2006.

15 The Korean mortgages represent a very good investment structured as residential MBS with robust credit risk mitigation arrangements – low loan-to-value ratio of around 50%, prudent seasoning requirement (weighted average seasoning of 16.5 months), and sizeable equity piece retained by the seller to absorb first losses. Foreign exchange and interest rate risks have been hedged through currency and interest rate swaps. Furthermore, pre-payment risk, collateral risk, legal risk, regulatory risk etc have been duly analysed and reflected in the acquisition price. Weighted average life is around three years.

16 The HKMC has a ceiling on the size of overseas purchases. The Corporation does not intend to expand its purchases in Korea beyond the current level.

Regional cooperation

17 The HKMC has established two joint ventures overseas in collaboration with the relevant central banks: the HKMC's business model is regarded as a successful model to address risks relating to mortgages and contribute towards regional financial stability.

18 The joint venture in Malaysia was set up in April 2008 with Cagamas, the national mortgage corporation in Malaysia (with 20% capital held by Bank Negara Malaysia, the Malaysian central bank) to provide mortgage guarantee for conventional and Islamic mortgage finance portfolios. The joint venture provides the HKMC with the opportunity to develop expertise in Islamic

mortgage finance. The capital structure is 100 million Malaysian ringgit with 50% held by each partner.

19 The joint venture in <u>Shenzhen</u> was set up in June 2009 in partnership with Shenzhen Financial Electronic Settlement Center ("SFESC") to provide mortgage guarantee. The SFESC operates under the leadership and supervision of People's Bank of China, Shenzhen branch. The capital structure is 100 million Yuan, with 90% held by the HKMC.

Hong Kong Mortgage Corporation
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