The Hong Kong Mortgage Corporation Limited
香港按揭證券有限公司

80/F Two International Finance Centre
8 Finance Street Central Hong Kong
Telephone (852) 2536 0089
Facsimile (852) 2536 0090

CB(1)686/09-10(01)

HKMC

James H. Lau Jr. JP 劉怡翔
Chief Executive Officer 總裁

14 December 2009

Ms Rosalind Ma
Clerk to Subcommittee
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Rosalind,

LegCo Panel on Financial Affairs
Follow-up to Meeting on 2 November 2009

Thank you for your letter of 3 November 2009 conveying the request for further information from the HKMC to address the concerns raised by the Hon Emily Lau.

Consultancy report

We have consulted the HKMC Board of Directors on the request for a copy of the consultancy report. The Board has decided to provide a summary (Annex A) of the consultancy report that set out the key considerations and recommendations of the consultant. The Board considered it not appropriate to release the full report as it contains sensitive commercial information and the release of which would jeopardize the interests of the HKMC and its ability in fulfilling its policy objectives.

Board's deliberations

A gist of the Board's discussions and decisions was already provided in LC Paper No. CB(1)2055/08-09(2).

To recapitulate, the Board decided on the HKMC's business diversification beyond Hong Kong because it is important for the Corporation to maintain its capability and readiness to discharge its core policy role as liquidity provider role to the Hong Kong's banking system, especially during times of finacial 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. Furthermore, the HKMC's overseas activities are often undertaken in collaboration with the relevant central banks.

The Board considers that the above paragraph is an accurate summary of the considerations leading to the decision taken on diversification. There is therefore no further information to provide.

Yours sincerely,

Encl.

c.c. Ms Anna AU, Senior Executive Officer (Financial Services),
Financial Services and the Treasury Bureau (Fax: 2528 3345)
Mr Andy Ching, SM(CD)/HKMA

Summary of key findings and recommendations

from the Consultancy report on

Strategic Review and Proposed Long-Term Vision for HKMC

1. In its market study, the consultant found that the HKMC has played an important role in helping to:

(a) maintain banking stability by providing liquidity to the banking system;

(b) facilitate the mortgage market to foster home ownership; and

(c) develop Hong Kong's debt market and mortgage-backed securities ("MBS") market.

2. Purchases from banks, which is a core business of the HKMC, have slowed down from a peak of HK$14 billion in 2002 to less than HK43 billion in 2005 because the banks in Hong Kong are highly liquid (with loan to deposit ratios declining from 110 percent in 1998 to less than 60 percent in 2005) and the new Basel II capital adequacy rules make mortgages even more attractive to retain on bank balance sheets. Purchases from the government or housing agencies have also declined due to reduction in their loan stock.

3. If these trends continue without any new business additions, HKMC's net income is projected to decline from HK$ 601 million in 2005 to HK$ 433 million in 2011. As a result, HKMC's ability to fulfil its core objectives will also be undermined. With mortgage purchases of only HK$ 2.5–3 billion per year by 2011 (about 2 percent of total annual origination), it cannot credibly claim to be facilitating Hong Kong's mortgage market. In addition, with a projected balance sheet of HK$ 20 billion in 2011, about half the current amount, its role of supporting Hong Kong's debt market and the development of Hong Kong as an international financial centre would also be undermined.

4. While it is understandable that in today's environment Hong Kong banks are generally reluctant to offload mortgages to HKMC, the safety valve role that HKMC plays in the Hong Kong mortgage market is still of fundamental importance. Furthermore, it performs this critical role in adverse circumstances, rather than in "fair weather".

5. It is therefore important for the HKMC to review its business strategy so that it can evolve with changing market conditions and continue to be able to meet its core objectives.

6. Three key business model options are recommended for consideration:

(a) Option 1: Focus on core mortgage business — essentially the same as the current business model with some expansion of mortgage business such as purchases through non-bank channels;

(b) Option 2: Expand to sustain — the HKMC would operate beyond its core mortgage business by entering into (i) adjacent assets (such as student loans, taxi loans, public light bus loans, auto loans and commercial mortgages representing almost HK$300 billion in purchasable assets in Hong Kong); (ii) selected overseas markets to make off-shore acquisition of mortgage assets or engage in mortgage insurance (e.g. China, Korea and Taiwan); and (iii) facilitating the financing requirements of government agencies through the Corporation's funding and debt market expertise;

(c) Option 3: Expand to perform — this would be Option 2 plus the purchase of small- and medium-sized enterprise ("SME") loans in Hong Kong, and expansion in overseas markets like China through direct entry and establishing a local presence.

7. It is necessary to move beyond Option 1 to maintain a reasonable size of HKMC's balance sheet and a sound financial position to support the delivery of its key policy objectives. Option 2 ensures that HKMC conducts enough business to remain viable, but limits the extent of its business and risk-taking. Option 3 on the other hand generates the highest financial returns and allows HKMC to most credibly fulfil its debt market development objectives, which is important to Hong Kong's status as an international financial centre; it is also the riskiest and most challenging to execute, given its higher investment and expansion requirements.

8. The choice between Options 2 and 3 depends on the **core beliefs** of HKMC's stakeholders.

(a) If the focus is mostly on fulfilling the core *mandate,* with less importance placed on *financial* performance, then Option 2 makes sense. However, financial performance expectations must be lower.

(b) If, in addition to fulfilling the core *mandate*, *financial performance* is also important, then Option 3 makes sense. However, one needs to accept the higher *risks* and ensure HKMC has the future ability to manage these risks by changing the approach to govern and manage the corporation.

If HKMC decides to go for Option 2 or 3, it should certainly consider a change in its name that better reflects its now broader business and geographical scope.

9. In both options, a key concern of HKMC's stakeholders is the impact of new expansion on creating additional competition with the private sector. While an expansion is necessary to fulfil HKMC's core objectives in a sustainable way, it will by definition have some impact on competition. However, we believe that the business expansions considered in both of these options are highly unlikely to have a material impact on crowding out competition. First, there are no significant and comparable players today in the Hong Kong wholesale mortgage purchase market and none to our knowledge for other assets. Second, the purchased mortgages represent today only 5% of the addressable market, while the projected purchases of non-mortgage assets by HKMC will be small to start with and will not be expected to be higher than 7% of total non-mortgage assets in the market by 2011. So long as HKMC buys assets at commercial terms from willing sellers and avoids direct origination, it will not be crowding out competition. Finally, HKMC will continue to set standards, such as in underwriting, thereby opening up markets for new entrants for example, in the asset purchase market.

10. Option 3 is recommended as it would offer the best long-term opportunity for the HKMC, with Option 2 potentially serving as a stepping-stone to move towards Option 3. Option 3 creates the potential to both reinforce the fulfilment of HKMC's objectives and enhance its value for shareholders, with the possibility of paving the way for a viable partial privatisation of the Corporation, with the Government retaining majority control and the Corporation still performing its intended role.

11. For investors to be interested, HKMC will need to demonstrate business momentum and financial performance against a clear and well-communicated business model. It will also need to develop public company capabilities, including investor relations and reformed governance, including a restructured board of directors, and a new organisation structure capable of executing the new business expansion.

12. As Option 3 is the most difficult option, it will result in a dramatic transformation of the business. HKMC's stakeholders will need to accept the higher risks and be confident in its ability to execute against broader expansion

plans. By expanding to perform and executing a series of organisation and governance changes that will ultimately lead to partial privatisation, the Hong Kong SAR will be capturing the value of a truly unique asset, while allowing a more effective fulfilment of its core objectives.