



Future of ALM: Different boundaries

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- **Treasury ALM**
 - Operational
 - “Snap Shot” view of exposure
- **Finance ALM**
 - Strategic
 - Balance Sheet Modelling
- **Scope**
 - Interest Rate Risk
 - Funding & Liquidity
 - Capital Management
 - FX Exposure

BUT:

Retail Interest Rate Risk: Can you look at in isolation?

P&L



Trends

- Credit Risk commoditised and traded.
- External stakeholder communication in a principles based risk environment.
- Treating customers fairly; the consumer lobby
- Margin compression and selling “options”
- Propensity to borrow > propensity to save
- Macro-economic environment: Low asset volatility
- Statutory Liquidity
- ALM in regulatory domain

Challenges for ALM?

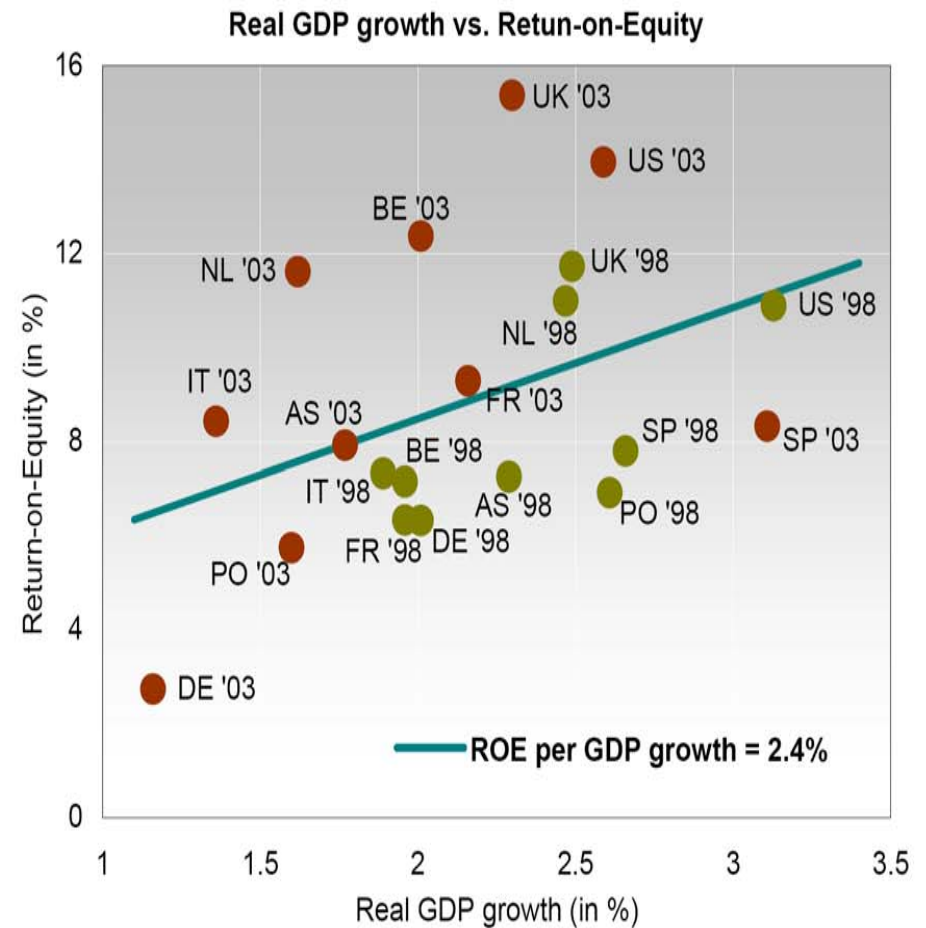
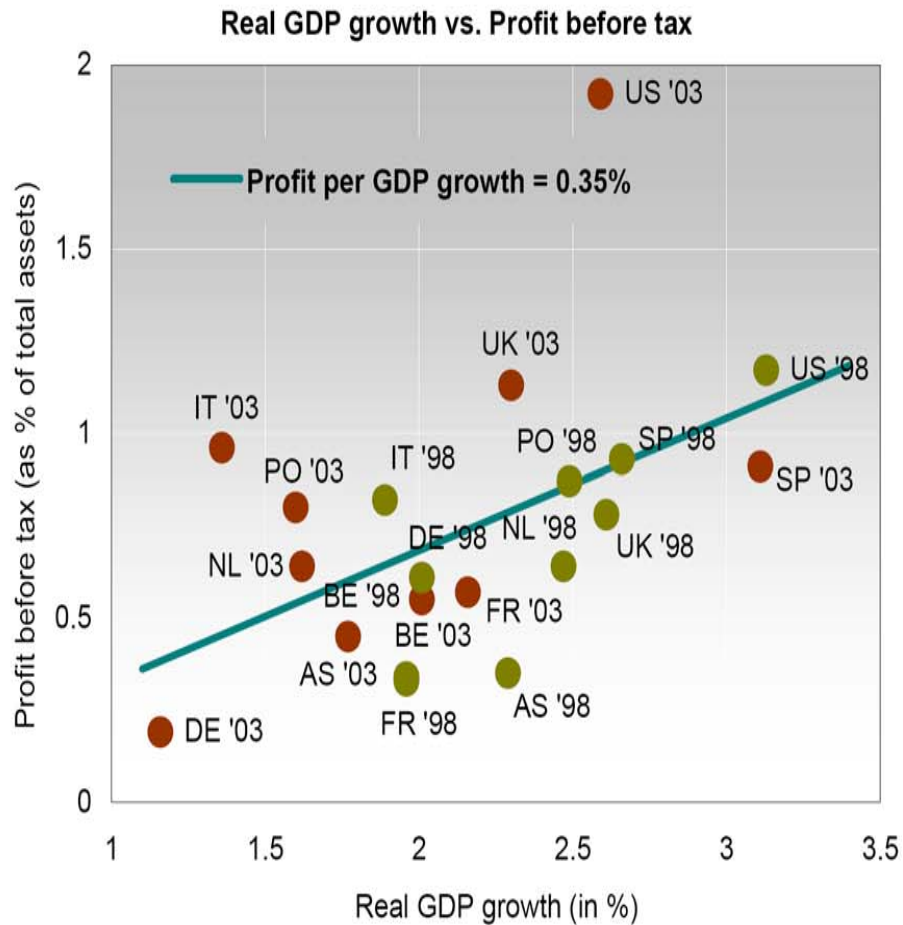
CAPITAL ALLOCATION

- Under Basel II. For higher risk asset classes, regulatory capital charges could be much increased. Will this result in greater origination and retention of the 'Winners? Will the change encourage you to shed exposures to the 'losers'? What do you retain?
- Will the double-default treatment of credit derivatives under Basel II encourage greater use of such products to hedge exposures in your banking book?

FUNDING

- How are you responding to changes in customer funding gaps?
- How will Basel II affect your choice between wholesale funding that moves assets off balance sheet (i.e. securitisation) and those that keep assets on balance sheet (i.e. covered bonds)?
- Do you see any material change in the liquidity of covered bond and securitisation markets driven by the Basel II's lower capital requirements, all else being equal, for banks investing in those products?
- Will Basel II influence the structure and targeting of the covered bonds and securitisations you issue?

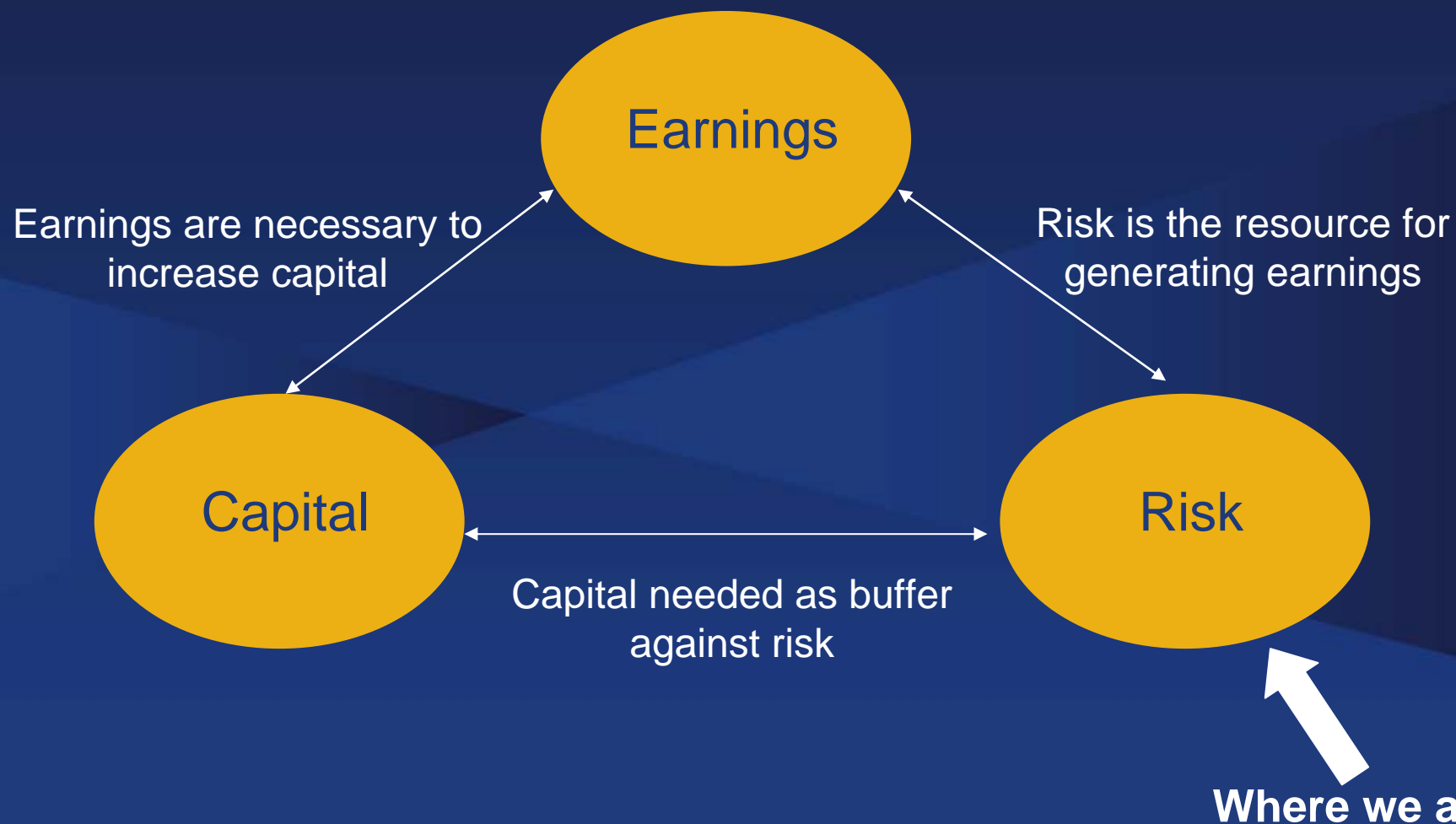
Historical link between profit and business cycles in industrialised countries (since 1981)



Source: Albertazzi and Gambacorta, "Bank profitability and the business cycle", *Banca D' Italia*, discussion paper 601, Sept. 2006.

WHAT DOES THIS MEAN FOR ALM?

ALM & Strategic Risk Management



Strategic Risk Management requires



- **Risk Appetite:** A more objective and top-down approach is required that links the strategic and capital management plans.
- **Strategic Planning:** Ensuring that Risk has a formalised and proactive role in the strategic planning process.
- **Risk and Capital Framework:** Install a more risk sensitive capital management and decision making framework.
- **Stress Testing:** Ensure that stress testing has a formalised role in the annual planning process and results are fed forward into the forecasting process.

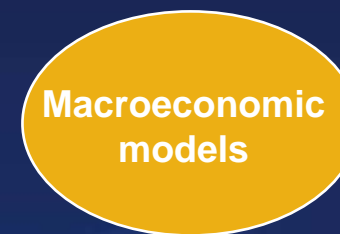
Macroeconomic modelling and the risk framework

Risk Environment



Primarily backward looking, market rates
Risk silos – credit, market – non additive

Macroeconomic Environment



Forward looking, economic and market observable factors chosen in context of the economic environment facing the institution

Consistently applied across organisation



- Translating to ALM –
 - Historical focus on modelling interest rates and FX only
 - Need to extend to other variables – rising interest rates could be seen in benign or negative GDP outlook
- Seeing a prevailing theme of integration across risk class

Risk Management: describing HBOS in a framework that reflects risk profile and adequacy of return

