BANK ANALYSIS

CAMELS – Sensitivity

Sensitivity refers to the risk of changes in market conditions potentially impacting a bank´s earnings or its capital base or both.

The sensitivity factor within the CAMELS system refers to the risk of changes in market conditions potentially adversely impacting a bank´s earnings or its capital base. Thereby, the term market risk refers to exposures usually associated with changes in interest rates, foreign exchange rates, commodity prices or equity prices. Among them the interest rate risk is of primary relevance to most banks. - Having said this, diversified bank operations are as a matter of fact vulnerable to various kinds of financial risks. Whereby, financial risk comprises next to market risk also risks linked to a firm´s credit, a bank´s liquidity, its systems and operations or else.

A sensitivity analysis helps to understand an institution's exposure to the various types of market risks. And in this context risk sensitivity is mostly evaluated in terms of management's ability to monitor and address all types of risks.

For example, in an environment of rising interest rates, the volume of financial assets or financial liabilities priced in terms of variable interest rates will subsequently determine the impact on a bank´s net interest margin: If, for instance, a bank holds foremost financial assets with fixed interest rates but financial liabilities with variable interest rates, then the net interest margin is expected to decline. In an environment with declining interest rates, this will be the other way round.

Or, if a bank extends a substantial amount of loans in a foreign currency and this foreign currency weakens, then also in this case the impact on the net interest margin will be detrimental. In addition, in this case not only interest income, but also the principle amount of loans would decrease. Hence, the value deterioration of loans would ultimately also weaken a bank´s capital base.

Sensitivities in regards to liquidity risk is another major focus area of banks: For example, an institution might experience sudden, unexpected cash outflows, or some external event causes counterparties to avoid trading with or lending to the institution, or a bank´s credit rating is reduced and subsequently the institution struggles with accessing funding,. Such sensitivity analysis may therefore also extend into assessing liquidity risks if markets on which an institution depends are subject to a general loss of liquidity.

Of course, there are cases when liquidity risk overlaps with, for example, market risk: For instance, if a trading operation has a position in an illiquid asset, this position may be difficult to liquidate at short notice. – Isolating liquidity risk may be cumbersome, but applying asset-liability management techniques may help, such as scenario analysis, simulating for market movements and defaults over a given period of time.

As far as regulators are concerned, these rather focus on systemic implications of liquidity risk: Form their perspective, the distinction between different categories of risk (market, credit, liquidity) is regarded as rather informal, with the boundaries between them blurred. For example, a loss due to widening credit spreads may be referred to as either a market loss or a credit loss.

Business as such risk refers to unexpected changes in business volume, margins and costs due to changes in customer preferences, increased competitive pressures or other changes in a bank's environment. Therefore, business risk also corresponds to managerial risks, a bank's capacity to adapt its policy to unexpected events and changes. – Part of this, by the way, are risks related to different regimes of market-value accounting vis-à-vis book-value accounting: In essence the representation of the state business is in. this is not only of relevance to investors, but poses also a challenge in regards to steering and monitoring a bank´s balance sheet.