

CAMELS – Sensitivity

Within the Camels framework, sensitivity refers to the risk of changes in market conditions, potentially having an impact on both, a bank's earnings as well as its capital base.

The risk of changing market conditions (i.e. market risk) usually refers to a bank's exposure to volatilities in interest rates, foreign exchange rates, commodity or equity prices. Among them, the interest rate risk is of prime relevance to most banks. – Of course, market risk is only one slice of the spectrum of financial risks which could potentially make a universal bank vulnerable, among others comprising risks linked to any client's credit, a bank's liquidity, its systems, its operations or else.

Sensitivity analysis helps to understand an institution's exposure to the various types of market risks. Whereby from an investor point of view, it is a bank's bottom line eventually determining whether management was able to spot and address relevant risk drivers.

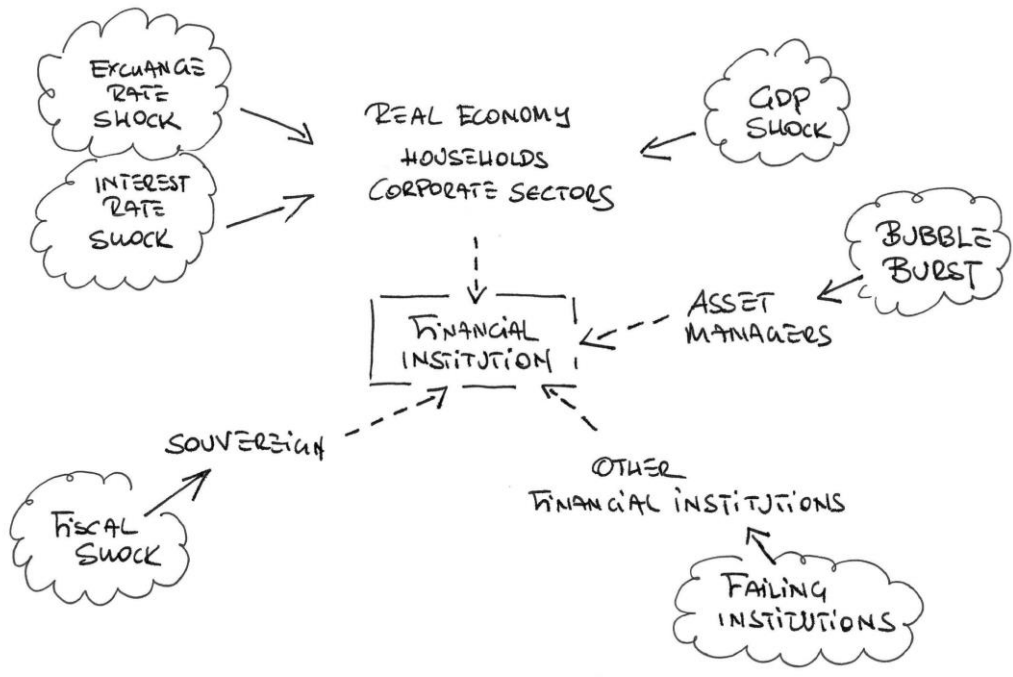
For example, with interest rates changing, a bank's relative exposure to interest rate-sensitive assets and liabilities will influence the impact on its net interest margin, indirectly also its capital position. If, let's say, a bank's assets were foremost with fixed interest rates whilst liabilities with variable ones, then with interest rates rising the net interest margin will suffer. In an environment with declining interest rates, this will be the other way round. Having said this, as interest rate changes also affect the price of assets (those with longer duration more than such with shorter ones), rising rates will deteriorate the value of fixed interest-related assets and in consequence directly harm the value of a bank's equity.

Or, if a bank extends a substantial amount of loans in a foreign currency and this currency weakens, then also in this case the impact on the net interest margin will be detrimental. And, as before, not only interest income, but also the respective loans' principal amount rebased in the bank's local (reporting) currency would decrease. Hence, the loans' value deterioration would additionally weaken a bank's capital base.

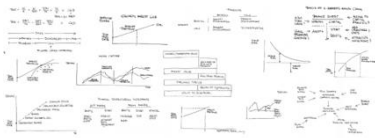
Whilst historically the sensitivity element within the Camels framework foremost addressed interest rate-related risks, with a special focus on banks' relative exposures towards certain dominant industrial sectors, this perspective has since significantly widened. This regards in particular overlaps of market-related risks with liquidity-related ones.

For example, an institution might experience sudden, unexpected cash outflows. Or, some external event causes counterparties to avoid trading with it. Or, lending to an institution is impeded due to a downgrade of its credit rating with the institution now struggling with access to funding. – Therefore, sensitivity analysis may also include assessing potential behavior patterns of markets an institution depends on, such as being subject to a loss of liquidity. – In this context, applying asset liability management techniques will help, such as, for instance, scenario analysis, simulating for market movements and defaults over a given period of time.

As far as regulators are concerned, these foremost focus on systemic implications, especially in regards to liquidity risk: From their perspective, the distinction between different categories of risk (market, credit, liquidity) is rather informal, though, 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.

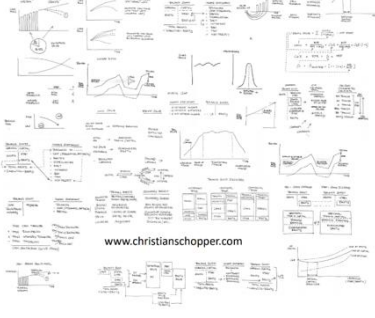


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