Tools and Instruments of Risk Assessment That Commercial Banks Use

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Executive Summary

With the changes in the financial market, the risks companies are facing are high. Technological changes are also observed in the risk-causing factors for commercial banks. Risk-taking is the engine that drives the business effectively. It is necessary to assess the vital components of market success. Commercial banks are faced with different kinds of risks in the world. The risks are not only monetary in nature, but there are certain environmental risks as well. Different kinds of risks include interest rate risk, deposits, loans, delays in the return of payments, default risks, regulations, and opportunity costs. The risks faced by commercial banks are addressed using tools and techniques. However, there are many bankers who follow traditional methodologies. Traditional methodologies used by bankers are effective, but there are loopholes in the techniques used. Traditional methodologies include economic capital and the value-at-risk technique as well. This paper critically analyses all the risks and the tools used for this risk management and assessment. Besides this, gaps in the regulatory environment have been assessed in this paper. Since the international markets of the United States and Canada are highly established, gaps are analyzed, especially in these countries. Regulations these days are uncertain and need more attention from the higher bodies.

Identify And Critically Examine The Tools And Instruments Of Risk Assessment That Commercial Banks Use, As Well As Gaps In The Regulatory Environment In Your Country/Countries Of Your Choice.

1.0 Introduction:

In the last decade, it has been observed that the financial markets have undergone various changes. These changes observed in recent decades are due to the deregulation found in past years. Besides this, instant liberalization and changes in communication have made commercial banks go through changes. Changes in communication are due to innovation in telecommunication. Commercial banks, in some cases, do not usually pay attention to the potential risks involved in these changes. The evolved mechanism, the idea of resolving the issues and bringing these things in line, needs attention to be improved. Besides this, commercial banks need to get in line with the global standards of commercial banks after analyzing the potential risk associated with all the changes (Ingves, 2004). As

the banks are no longer operating in an imperative and protected environment, there is a need for all commercial banks to utilize tools and instruments for risk assessment. These tools then help in managing risk assessment as well. In this paper, a critical examination of the tools and instruments used in commercial banks will be conducted. Besides this, the gaps in the regulatory environment, specifically in the environment of the United States and Canada, will be observed.

2.0 Literature Review:

In this section, risks associated with commercial banks, tools and instruments used in risk assessment, and their critical analysis are mentioned.

2.1 Risks for commercial banks:

Commercial banks are one of the important parts of the financial negotiators in the marketplace. Due to the prominent role of commercial banks, there are certain exposed risks. These risks affect the security of the market and the economic conditions. These market and economic conditions are related to the consumers of the world. To understand the risks associated with commercial banks, there are areas of banking operations that need to be understood.

2.1.1. Interest Rate Risk:

One of the most dominant risks observed in commercial banks is the interest rate risk. In general, it is observed that commercial banks are good at enhancing the interest rate risk in the portfolio of their investments. Another fact that needs to be observed is that the interest rates fall out of the territory of commercial bank operations. There is a considerable influence on the interest rates observed in the Federal Reserve, which is the main bank of the United States. As a result of this, commercial banks are observing their loans and the changes in the general interest rate. The interest rate level of the economy is a considerable fact that needs to be observed. If a bank makes a business loan and charges a certain interest rate, profit will be made by the bank.

2.1.2 Default Risk:

The maximum amount of money made by commercial banks is in the form of loans. The process of borrowing is filled with the process of screening and analyzing the financial position of the borrower, the paying ability, and any susceptible activity if found. In a situation where borrowers are unable to pay the default loan, the bank suffers a monetary loss. However, the general analyses of commercial banks have shown a small margin of default. The widespread default of borrowers risks the monetary benefits of the bank.

2.1.3 Regulation:

Subjection to the concept of regulation is also noticed in commercial banks. The regulation mostly depends on the type of bank they are operating in. Besides this, the specialization and state in which the operations are being carried out are analyzed in the framework of legal regulation. Minor changes in the regulation come up with changes in the framework as well (Fuentes, 2010). This also impacts the profitability of the bank. For instance, one of the main banks of the United States, the Federal Reserve, can increase the reserves with customer cash withdrawals. However, profit reduction may be observed when the bank decreases the capital available.

2.1.4 Opportunity Costs:

The fear of widespread default in certain cases makes the banks end the concept of taking loans. Diminished economic activity observed in the financial analysis of the bank makes the commercial bank ask the borrowers to repay the payments.

2.1.5 Deposits:

Commercial banks depend on the deposits made by customers to some extent. These deposits are beneficial for bank funding available in the form of investments and loans (Fuentes, 2010). Other than offering traditional banking services, the bank offers certificates of deposit and checking as well. Savings and money market accounts are other bonus offers made by commercial banks. Banks may tend to increase the interest rate payments.

2.2 Tools and instruments used in Risk assessment:

Bankers share a unanimous approach related to risk management techniques and efficiency related to risk management techniques. The performance and success of the banks depend on the management of risks. Many risk management techniques reduce costs and expected losses (Moreno, 2014). This thought has been shared by managers as well. Below are some of the commonly used techniques for risk assessment:

2.2.1 Economic Capital:

All risk-adjusted performance is assessed using the economic capital technique. Economic capital defines the actual risk profile of an organization (Abdelghani, 2018). In some organizations, the individual risk types are calculated separately while putting an emphasis on the idea of enterprise for the calculation of economic capital. Major risk types faced by organizations of a larger scale are understood with the association of economic capital. However, there are some loopholes left by

organizations while using the technique of economic capital.

2.2.2 Traditional methodologies for credit risk management:

In measuring credit risk management in economics, finance, and business, most organizations rely on traditional methods of measuring risks. The traditional methodologies are widely accepted and managed by organizations. For assessing credit risk management, usually, organizations use the probability of default technique. This probability of default technique is followed by the loss given by default. Other important things included in the conventional methods are exposure at default and the principal approach. In some cases, the use of the Friedman test has shown that the differences in the ranking of the credit risk measurements are nearly negligible.

2.2.3 Value at risk for assessing market risk:

VAR stands for value at risk. Value at risk is a long-accepted methodology. This methodology is used for assessing market risk. For the trading profiles of the banks and risk management purposes, the VAR method is widely used. There are three statistical components observed in the method of value at risk. The time period for which the country is observing the risk, confidence level, and amount of loss are the components of value at risk. The amount of loss is actually the loss percentage. There are certain value-at-risk questions that arise in the minds of the people using this technique. The questions relate to the maximum loss in the next month in dollars and the maximum percentage of loss. Value at risk is the new science of risk management. However, to use this technique, it is not necessary for the person to be a scientist. Investors have mentioned their odds of losing money. The use of common sense is prevalent in the value-at-risk technique (Will, 2018).

2.2.4 Friedman test for the progress of implementing operational risk management:

The Friedman test is used for implementing operational risk management. The factors included in this test are the key risk indicators, that is, the basis of the risk in the business, external loss event analysis, and the causal event analysis as well (Maffini, Neltner and Vogel, 2018).

3.0 Critical Analysis Of The Tools And The Instruments:

This part of the research analyses the tools and techniques for risk assessment. Risks are identified first and arranged according to their priority. This priority list is managed according to the size of the threat the risk is posing. In this, innovations are introduced. Innovations are a big way to create

enough opportunity. Then, the techniques are implemented, or an innovation is brought to the market.

3.1 Analysis of Economic Capital:

Many researchers believe that economic capital is one of the relevant methods for analyzing risks in the environment of commercial bank risk assessment. The relevance of the method can be analyzed from the fact that it provides key answers. The key answers are most of the time relevant to the business decisions taken by commercial banks. In another case, the key answers are necessary for evaluating the financial units of the banks. An instrument is provided by economic capital for comparing RC. Economic capital estimates can be effectively used by the banks to allocate capital. This capital is allocated across the business strategies and in the promotion of the units that provide profit according to the desire of the banks. The performance measure involving risk adjustment capital and giving economic capital in return is one of the examples of the effectiveness of economic capital. Another point of effectiveness of economic capital can be analyzed from its utilization in comparison with RC. Besides this, measuring RC is an easy and less time-consuming process. This puts this process in high demand among all the bankers planning on measuring credit risk management.

3.2 Analysis of Traditional methodologies for credit risk management:

Although the use of traditional methodologies for credit risk is widely observed, there are some loopholes in this technique of assessment. Many researchers believe that if the traditional method is employed, then the analysis of the market, debt, and equity can never be estimated close to reality. There is always a significant gap between the calculated value and the actual values existing in the credit risk for commercial banks. Besides this, the banking system of the present time has the dominance of people from the old times. No doubt there are new technologies and ideas being implemented, but the mindset has not changed yet since the old generation is comfortable with the traditional techniques. Besides, the traditional techniques are an easy way of getting things done in credit risk management, although there is a need for improvement.

3.3 Analysis of Value at risk for assessing market risk:

Value at risk is considered to be one of the most reliable sources for risk assessment in commercial banks. This method is not restricted to financial transactions only. There are many other dimensions on which this method is applied. The main focus of VAR places importance on the downside. Downside means that the risk and potential losses pose a risk. The risk posed to commercial banks is mostly in the form of loans when the borrowers are unable to pay the default back. The utilization of this technique in the banking system basically reflects the fear of a liquidity crisis. In this situation, many

widespread banks and Nobel Prize winners have declared VAR a reliable source for analyzing the demise of long-term capital management (Thamhain, 2013).

2.2.4 Analysis of Friedman test for the progress of implementing operational risk management:

The Friedman test is one of the alternative ways of measuring ANOVA with repeated measures being carried out in the atmosphere. The differences between the group and the original measured values are measured using the techniques of this test. The reason this test is not used in calculations is due to the limitation involved in this test. Only when deviations in the data are observed is this test applied.

4.0 Gaps In The Regulatory Environment:

The current regulatory environment is changing at an accelerating pace. The pace of regulations needs to be matched; otherwise, the requirements of all such regulations will not be understood in time.

4.1 Gaps in the Regulatory Environment in the United States:

The intensity seen in the current regulatory environment is due to the imbalance observed in the financial market. This imbalance has led the world to the situation of the collapse of the financial system. An acute economic downturn was observed six years ago. In this situation, the regulations were believed to be the cure for the situation and acted as a preventive measure as well. This is how the business was intended to be changed. However, definite evidence is obtained about the latter being attained. The regulatory environment is the top issue that can impact most companies in the United States. Nearly 400 chief executive officers in the United States stated that they are spending more time on regulators, while some are paying attention to completing this act.

The regulatory environment in the United States mostly affects the health sector and financial services (Thamhain, 2013). As far as the financial sector is concerned, an overall reduction in the market risk is being observed by regulatory mandates directed towards the idea of transparency. The number of regulations that researchers see coming on companies can be hard to handle. At present, there is a need for companies to transform their data tracking methods. Besides this, the companies need to focus on the data-gathering systems, the functions being used for reporting and, in some cases, the organizational structures that need revision. Hence, all the new regulations are expensive when it comes to compliance. Although these regulations are necessary, they come at a cost since they can limit the generation of revenue and profitability. This limitation can occur due to the

increasing capital ratio necessities.

Besides this, limitations are applied to certain products and activities as well. The current regulatory environment has been put into correct words by the CEO of Prosperity Bank. He mentioned that from the year 1978 until now, most of his time has been spent managing the regulatory environment and the consequences associated with it. The regulatory burden at present is a burden to the community, especially the community that is traditional when it comes to the banking environment. The biggest dilemma in regulations is that the purpose of such regulations is not known in every situation. The idea of chief executive officers devoting a higher amount of time to regulation does not seem to be a good idea. In this case, no special choice is left for the CEOs to implement in the environment. The global pace of regulations is increasing every now and then. In this situation, the major financial issues or gaps created by the regulatory environment for commercial banks in the United States have come in the form of six major issues:

- Corporate tax reform
- Global economic growth

4.2 Gaps in the Regulatory Environment in Canada:

Current regulations being observed in Canada differ from the traditional consequences. The present time has shown that the regulations observed in Canada are not restricted to specific needs. There is uncertainty observed in the requirements of the regulations. The regulations and their uncertainty add costs and risks faced by banking-associated people. New regulations are being observed in the framework by the Department of Finance of Canada. After the observation of this regulation, the country has decided to promote innovation and competition in financial services. New payment plans are being observed and implemented throughout the country. If interoperability between payment platforms is built into this system, it will spur competition and innovation. However, because a system with high interoperability requires significant collaboration, a strong governance framework is needed to prevent incumbent members and early entrants from strategically developing rules that exclude others from entering this sector in the future.

5.0 Conclusion

To sum up, the research highlights the risks that are associated with the financial conditions of commercial banks. Risk can be of different types. Starting from the main line and ending with the complex issues, there are many tools and techniques used by the owners and bank executives to make the environment of the banks better. Nowadays, regulations are widely observed. The regulations are uncertain and do not come up with specific needs and requirements. In this case, specific examples of the United States and Canada are being observed at present. The United States has certain major issues due to regulation, to which CEOs are giving more time. In Canada, the regulations are highly complex.

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