Diversification of Banking Risks in the Context of Financial Globalization

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Abstract

Diversification of financial activity involves the use of alternative income opportunities from various financial transactions - short-term investments, formation of the loan portfolio, portfolio of long-term investments, and the implementation of real investment. In today's highly integrated monetary relations, risk is not an integral part of the economic system. Sensibility to risk increases; factors of its occurrence are becoming more diverse, and the opportunity to diversify and these risks is less realizable in practice. Diversification of banking risks in the context of financial globalization is the basis for the stable operation of the Russian banking sector, in the context of rapidly changing external and internal market conditions, creates a safety factor of strategic development and reform the economy as a whole. Understanding that the risks for the banking activities are not so much the potential loss as possible benefits, involves the development and implementation in practice of new concepts and models of risk diversification for banking activities, leading to the quality of its content mandatory requirements of regulators in the area of risk control.

Keywords: diversification, banking risks, financial globalization

1. Introduction

1.1 Introduce the Problem

Despite the variability of research conducted by scientists and practitioners in the field of risk diversification of banking activities, most of the questions in this sphere remain debatable. Absence of uniform standards, common and harmonized methodology of risk diversification of banking activities shows insufficient knowledge of this problem.

Development of market relations and high rates of financial globalization lead to permanent transformations risks that require new approaches and management practices.

The degree of scientific problem elaboration: Discussion of the problem of diversification of banking risks in the context of financial globalization requires adequate reflection in scientific and applied research, revealing the theoretical

and methodological aspects of risk management.

1.2 Importance of the Problem

Relevance of research is determined by the necessity of solving scientific and practical problems of ensuring the profitability of the banking activity with increasing concentration of risk and limited capacity of the banking sector to attract funding.

Results of the study are expanding industry-specific functioning of the Russian banking sector; deepen the theoretical and methodological basis for the development of more effective mechanisms for risk diversification of banking activities.

1.3 Relevant Scholarship

Key findings and recommendations of the thesis were presented, discussed, and approved on the following events:

- The Russian forum of young scientists and students "Eurasian Economic Space: Issues and Trends of Development", Moscow, 2009;
- All-Russian scientific-practical conference "Spiritual and value bases of education of the individual in the system of continuing professional education", Ekaterinburg, 2010;
- XI V All-Russian Economic Forum research works of young scientists and students "Competitiveness territories" dedicated to the "world and national economy: features and trends of development", Moscow, 2011;
- XV National Forum of Young Scientists with the International participation in the III Eurasian Economic Youth Forum "Dialogue of Civilizations - "THE WAY FORWARD "", Moscow, 2012;
- IX International scientific-practical conference on the problems of economic development in the modern world, Ekaterinburg, 2012;
- International scientific and practical Internet-conference of young scientists and students, Lutsk, 2013; XI All-Russian Forum "Youth Science Russia: Reloaded", Ekaterinburg, 2013;
- International scientific and practical conference on the problems of economic development in the modern world, Ekaterinburg, 2013;
- VII Annual All-Russia with international participation in scientific-practical conference, Perm, 2013;
- International scientific-practical conference, Ufa, 2013; and
- XI International Conference on "Sustainable Development of Russian Regions", Moscow, 2014

1.4 State Hypotheses and Their Correspondence to Research Design

Russia's banking sector is one of the major growth segments and capitalization of all of the domestic market, on which the one hundred stability and financial stability of the economy as a whole. Anyway, the redistribution of cash flows and investment cannot be realized without going through the banking sector, so diversification of banking risks in the current conditions of financial globalization seems to be one of the priorities of the study with the aim of successful practical implementation of modern risk management techniques.

Author's research has shown that the need for an integrated approach to risk diversification of banking activities due to a high rate of transformation of modern risks and atypical manifestation of risk. Methodological and practical solutions proposed by the authors in the field of risk diversification of banking activities in the context of financial globalization form the analytical basis. The authors set the correct vector for further research to improve the efficient adaptation of the Russian banking sector in terms of more stringent requirements of both external and internal. In addition, it contributes to the successful transformation process to overcome risks and new forms of expression.

In the context of financial globalization, the banking sector is able to significantly increase the volume of gross domestic product, conquer new economic niches, and unleash their innovative potential. This requires quality mechanisms for risk management of the banking activities that contribute to adaptation to current participants to risks and self-protection of the industry in the event the concentration of these or other risks. Determination of the degree of risk, the ability to adopt and effectively level the increased risks of banking activity will determine the future competitiveness.

2. Method

2.1 Method of statistical monitoring

Theoretical and methodological basis of research is as follows:
- The economic and financial situation of science in the modern sense of the classical and conceptual standpoint of the theory and practice of risk diversification of banking activities;
- Monographic publications, revealing patterns of relations in the system of risk management; and
- Program and methodical developments of the professional participants of the banking market.

The methodical apparatus of the research includes various methods of knowledge of economic and social phenomena. We used historical and logical, graphical, statistical and economic-mathematical methods of information processing.

2.2 Method of analysis and measurement

Financial globalization in general, of course, affects the globalization in the banking sector in particular. This is manifested in the averaging of risk of banking activities for all participants of the process because of the impact of the integration of markets, economies, private corporations, and monopolies. In this paper, the authors presented the integration movement mechanism of integration of economic processes taking into account the impact of financial globalization on the results of the monetary policies of countries. Stable banking system is essential for the safe operation of the state, it is necessary for the successful development of the economy, as it provides financial and credit services in all economic turnover of the country (Figures 1,2).
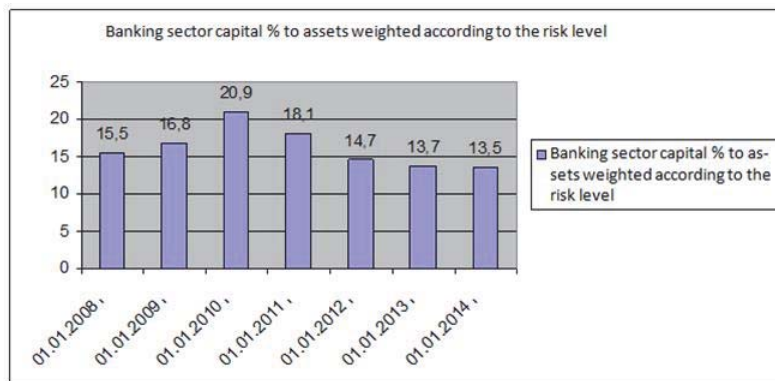

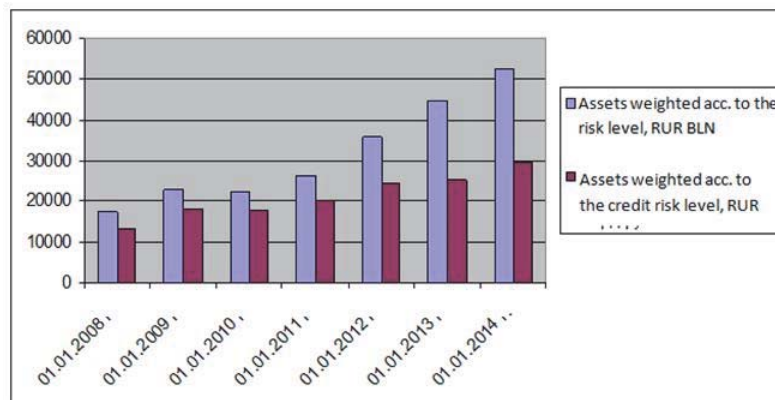**Figure 1.** The capital adequacy of the banking sector in Russia, %

Figure 2. Dynamics of assets weighted by risk level, bln. rubles.

There is a process of banks' capital expenditure, followed by growth of assets, additional provision, which negatively affects the profitability of banks (Table 1).

Table 1 - Financial result of operating credit organizations (COs)

Ratings	Volume of profit (+)/loss (-) for the current year, bln rubles					Amount of the credit organizations				
	Jan 01, 2010	Jan 01, 2011	Jan 01, 2012	Jan 01, 2013	Jan 01, 2014	Jan 01, 2010	Jan 01, 2011	Jan 01, 2012	Jan 01, 2013	Jan 01, 2014
CO, total	205.1	573.38	848.2	1011.8	993.5	1,058	1,012	978	956	922
Including: profitable CO	284.9	595.05	853.8	1021.2	1012.2	938	931	928	901	834
detrimental CO	-79.83	-21.67	-5.63	-9.36	-18.67	120	81	50	55	88
CO w/o reporting	0.0	0.0	0.0	0.0	0.0	0	0	0	0	1
Total						1058	1012	978	956	923

With the reduction of the total number of credit institutions, the number of unprofitable ones is growing, i.e. we can observe increase in the share of such organizations in the structure of the Russian banking system.
Credit growth in the system as a whole is in a dangerously fast pace, and is particularly acute, these trends are manifested in the retail segment: increase of overdue loans to individuals may negatively affect the major retail banks and require additional capitalization, and this may lead to a loss.

2.3 Taxonomic method

Effective risk management requires specific management goal, because only if it is available, it is possible to influence certain risk parameters. Integrated diagram of bank risk management methodology is presented in Figure 2.
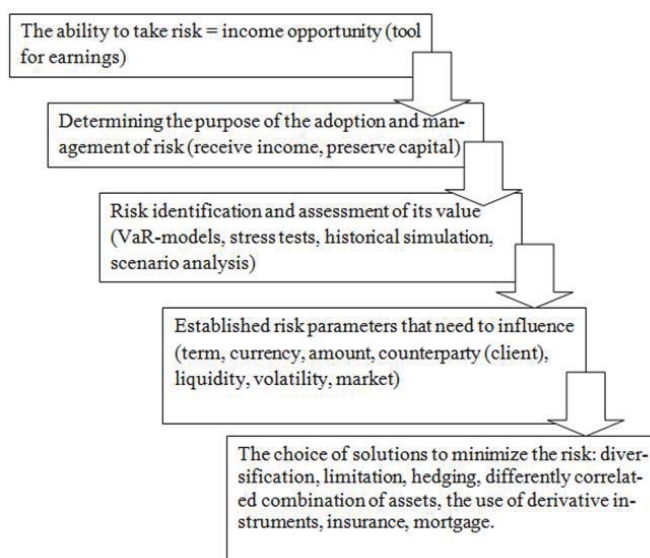

Figure 2 - Integrated circuit management methodology for the banking risks

For the purpose of effective risk management, it is necessary to compare their estimates obtained by different methods. The bank must determine the level of acceptability of risks, because it is, first of all, determines the profitability of the bank's operations, risk management should be regarded as one of the stages of activity that must be managed efficiently and in a timely manner.
　　　　Bank risk management is a set of mechanisms of interaction between the various units of the credit institutions, providing a positive financial result of the instability and insecurity of the profit. Thus, they allow estimating and predicting the degree of risk and the probability of its occurrence, as well as helping to take appropriate and timely action to level negative consequences of the risk. The ways to limit the impact of risk on the bank's activities consist of the operational

risk management and methods of localization and elimination.

Operational risk management is the monitoring of indicators beyond acceptable values, and develop solutions for current operations of the credit institution, which may cause the indicator to the desired value.

2.4 Method of observational generalization and logical inference

For a decision to minimize the risk, it is necessary to carry out a comprehensive risk assessment, the current at the current market conjunctions. For this purpose, the quantitative and qualitative analysis was carried out. Analysis from a position of quality is an assessment of sources and potential risk areas, defined by its cause. It relies on the unambiguous distinction of reasons, the list of which is specific to each bank risk. Quantitative risk analysis seeks to determine numerically the degree of risk, i.e. the maximum potential loss.

Risk monitoring is a permanent process of analysis of risk indicators, aimed at its identification, prevention, and minimization of further while ensuring an adequate level of profitability.

International and domestic experience of commercial lending institutions allows us to formulate the rules for constructing interbank risk management system:

- The presence of a single management structure for all types of risk;
- Features of the content of individual elements of the system in relation to the types of banking risks;
- Common information base; and
- Coordinated management of different types of risk.

To reduce the negative impact of possible risks, CBR implements the control and supervision of commercial banks, banking laws, regulations and regulator set of mandatory standards.

According to the regulations of the Bank of Russia No. 242-P "On organization of internal control in credit institutions and banking groups" as of Dec 16, 2003, the management of banking risks is defined as follows:

- Identification, measurement and determination of an acceptable level of banking risks;
- Continuous monitoring of banking risks;
- Adoption of measures to maintain the stability of the credit institution.

As noted above, in risk management it is important to comply with banking laws, and comply with regulations set by the regulator (in Russia - the Central Bank of the Russian Federation).

As of 1 January 2014, Russia began the implementation of standards "Basel III", which are designed to strengthen the resilience of the banking system, strengthen supervision and management of banking risks.

The last direction is realized through:

- Enhanced surveillance, increase transparency of the banking statements;
- Stricter capital requirements;
- Change and the introduction of additional capital adequacy (N1.1 and N1.2);
- Identification and elimination of risks on an ongoing basis.

All standards "Basel III" are aimed at establishing more stringent requirements to the credit institutions. However, according to experts, the gradual introduction of these changes (2013 to 2019) will allow banks to move painlessly to the new conditions.

The implementation of the methodology of "Basel II" banking market will get rid of the "weak", financially unstable participants. Firstly, the banks, whose capital or the sufficiency of capital will be lower than the permissible level, will either be eliminated or converted to other credit institutions. Secondly, the establishment of high standards of size and capital adequacy will make it possible to minimize credit, market, and operational risks; it will improve the quality of banks. Thirdly, the disclosure by banks of information about us estimate separate it risks increase the transparency of the market.

As a result, "Basel III" will have a huge impact on the banking system subject of Russia. Apart from the fact that the banking system will match international standards, its resistance to crises in the economy will be increased. Ratings of the banks will increase, which will allow them to enter the international market with competitive advantages, which are now, unfortunately, absent.

Risk analysis (evaluation) first shall be made to improve the quality of their management. As rightly pointed out by T. M. Kosterina, "in terms of volatility of the financial markets, extremely high risks, non-perfection of banking legislation, often contradictory policy of the monetary authorities and other problems of the Russian economy, the strategy of banks shall be improved constantly and the strategic management process should be reviewed regularly in accordance with quickly changing external and internal factors of the business environment". However, the measures proposed to address the problems are retrospective in nature, i.e., aimed at the elimination of mistakes of the past, rather than preventing

them in the future.

3. Results

Regular surveys of financial condition of a client. At the moment, there is no fully unified and formal methods for such analysis. Therefore, based on the experience of American credit institutions, we may synthesize a basic model of this analysis (in the literature, it is usually called "standardized approach"). It relies on the fact that the bank, optimizing options for providing loan resources of several potential borrowers prefers more reliable. Thus, the bank ranks them by assigning each priority rating of the loan. Bodies performing control over the banking sector, make a list of credit agencies, whose ratings may be used in the calculations. Many rating agencies are subsidiaries of large holdings. The activity of the rating agencies acquires new economic sense in connection with the requirements of the Basel Committee in the field of capital adequacy.

The Basel Committee proposes to weigh the type considered assets at the following level of risk (Table 2).It uses the credit rating by Standard&Poor's, which has a number of advantages for issuers and investors, lenders and financial intermediaries.

Table 2 – Weighing the types of assets by risk

Credit rating Assigned by the agency	AAA - AA	A + -A-	BBB + -VV-	Below BB-	Rating Not rated
Risk, %	20	50	100	150	100

All standards, as reflected in the Basel Committee, are assumed a reference point. Compliance risk rating percentage set org Ana overseeing the banking sector, based on objective factors, including historically probability levels of default of the company. These data are public and are disclosed by agencies on a regular basis.

It is necessary to distinguish the concept of "rating" from the "ranking". Ranking is a list of companies ranked by any criterion. Generally accepted is ranking companies by descending values of one of the financial indicators. The most common and universal from the point of differences in professional activities are the indicators of the assets and capital of the company or a bank. In this case, depending on the focus of professional interests are more important information to rank the banks may be data on the size of the loan portfolio.

Diversification of risk due to the possibility coating losses in one of the segments of the bank gains in another. The essence of this risk reduction is the differentiation of industries and areas of worker clients, transfers between unrelated companies with each other. Also, the terms of the loans (adjusting of the share of short-, medium- and long-term investments depending on market conditions) are differentiated, providing targeted resources (for the purchase of equipment, replenish working capital, etc.), collateral type, method of establishing fees provision of resources (fixed or variable rate of interest), etc.

Issuing large loans by the pool from several banks (the division of responsibilities and risks between the parties).

Setting limits of individual parameters, such as the functioning of the financial results. The use of such generally accepted in the international practice limits as stop-loss, stop-out, take profit and take out, make it possible to control efficiently the level of damages.

Compliance with mandatory norms set by the supervising bodies. Analysis of the state regulations are subject to risks actually allows representing actual financial position of banks.

The introduction of floating or variable interest rate - floating or variable interest rate is determined by market conditions, as it is "tied" to one of the indicators of the market, such as the rate of LIBOR.

Application of the lien. Using a mortgage scheme, the bank shall identify assets that may be the key at the conclusion of credit transactions, and the mechanism of calculating the cost of credit. In assessing pledged assets, it is necessary to consider their main characteristics: the speed of their placing on the market; volatility in the market price of the asset; identification and location of collateral available encumbrances; determine the probability of loss of value of the collateral and its main consumer qualities. Mortgage banking operations are not separate and independent transactions are considered in the context of lending operations and reduce risks to them.

In foreign practice, assessment of the quality (reliability) of the collateral uses the following set of criteria:

2) The ratio of the value of the mortgaged property and the loan amount;
3) The liquidity of the mortgaged property;
4) The bank's ability to exercise control over the mortgaged property.

In accordance with the above criteria are five groups pledge of different complexity of his subjects (Table 3).

Table 3 - Criteria for assessing the quality of the collateral mechanism

Rating Reliability	Ratio of value for mortgaged asset and loan amount	Liquidity of the pledged items	Opportunity to carry out control for the pledged subject	Examples
A	More or equal 100%	Easily implemented	Fully under the control of bank	Cash deposit bank
B	Less than 100%	Price may fluctuate and there may arise difficulties with the implementation	There problems with control	Listed securities forwarded to the bank deposited
C	Less than 100%	Price may fluctuate and there may arise difficulties with the implementation	There problems with control	Unlisted valuable shares. Commodities and materials stock of the client
D	Less than 100%	Price decreases; there is a problem with the implementation	There problems with control	Unlisted valuable shares. Commodities and materials stock of the client
E	Less than 100%	Price decreases	Control is missing	Inventories values are located with client

In the Russian practice in accordance with requirements of the Bank of Russia, quality of the collateral is divided into two categories based on the degree of liquidity of his subjects. The first category of quality covers public and corporate securities having a certain minimum rating, precious metals bullions, real estate, and deposits. Thus, this category includes assets, possessing the high degree of liquidity even in unstable market conditions. The second category of quality includes assets that are less liquid in the region and may be taken as collateral only with correction factors - the securities of issuers with low credit rating, property rights, guarantees and warranties with restrictions, etc.

Hedging strategies mean a set of transactions, including futures, allowing neutralizing the risk of changes in value of the asset in an unfavourable direction in the future.

Using the currency basket, i.e. minimizing the currency risk by means of the use of multiple currencies or assets denominated in them having an inverse correlation. In the process of changing of currencies' prices against one another basket as a whole remains neutral and not subject to currency risk, as the decrease in the value of one currency is offset by an increase inversely correlated currencies.

The use of different insurance schemes, i.e. minimizing the currency loss when the insured event. Also, it is possible to use various methods of redistribution of commitments: co-insurance - insurance of the same object of insurance by several insurers in certain proportions; double insurance - insurance from several insurance companies of the same type of risk; reinsurance - new insurance already insured risk.

On the bank influences the riskiness of its clients. Propensity to risk the client can be determined based on what conditions investments or loans he chooses from a position of safety. Typically, high-risk tolerance is fixed at 2.5% of the sample respondents, and crisis periods in 1998, 2008 the number of such respondents increased to 7% in the post-crisis - reduced to 3%. However, the results of surveys in 2012 again recorded an increase in risk to 8% with the reduction in 2013 to 2%.

The maximum proportion of respondents with a low propensity for risk - about 60%, the proportion of people with an average risk appetite is about 30%. More detail the dynamics of propensity to risk is represented in Figure 3.
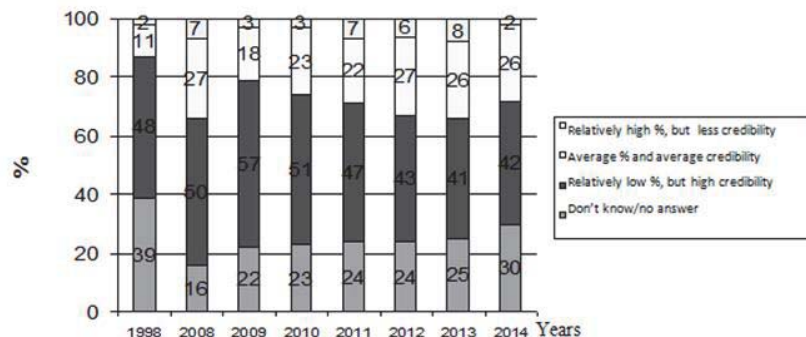

Figure 3 - Dynamics of propensity to take risks in 1998-2014

The first shift in the direction of improving the quality of risk management of the banking activities occurred in 2004. It was the period, when even bigger number of credit institutions switched to the use of International Financial Reporting Standards (IFRS). In addition, the new regulations of the Central Bank of the Russian Federation regulating banking activities appeared, and the active preparatory phase to the implementation of the "Basel III" method started, one of the parts of the method affects the management of bank risks.

4. Discussion

In order to develop methodological issues of banking risk management authors conducted an empirical analysis of modern methods of bank risk management, resulting in the following conclusions:

1. The predominant use in assessing the risk of credit rating classifications of "Standard & Poor's", "Fitch Ratings", and "Moody's". This is an estimate of a default of the issuer based on those data, which are in the public domain, as well as their understanding of the processes taking place at markets and states. In view of these circumstances, the vast majority of the methodologies of risk management used credit ratings to assess the quality of the asset and risk. Disclosure to the investors of complete and reliable information about the issuer is the main objective for the activities of these agencies. Without assigning such a credit rating, it is very difficult to obtain funding in the capital markets. This activity of agencies is paid, i.e. it is paid by the recipient of the rating on an annual basis. The question of confidence in the activities of rating agencies was raised many times by the international community. Sharp and not fully proved decrease in Russia's sovereign rating to just a "junk" level at the beginning of 2014 because of Western sanctions caused bewilderment in professional circles. There is a crisis of confidence in the work of these agencies, their economic and, more importantly, political independence. All these participants are located in the United States and may be under pressure from the government, whereby the desired state of affairs may be issued for the real and activities on rating can become a weapon of economic and political pressure.

2. The lack of single, unified standards of risk management. There are many methods, solutions in the field of risk management, which applied in practice, banks, corporate treasuries, invest, and communicable companies etc. The present situation is such that each participant of market relations, aimed at investment and capital investment, i.e. associated with high-risk activities, generates its own model of behaviour and strategy, assessment, management, and minimizing risks, which can be effectively used to them, but may not be usable by another entity. There is a diversity of opinions, as well as theoretical and practical discrepancy in this poll.

3. The use of different accounting standards and reflection of financial activities of credit institutions from different countries. Russian accounting standards (RAS) differ significantly from international accounting standards (IAS), which, in turn, are not identical to US standards (US GAAP). These differences, of course, increase the risks associated with an investment in the company in different markets, as performance indicators of the company for a variety of accounting method may be different and, accordingly, investment attractiveness becomes different. Currently, the international accounting practice has the two most popular systems: International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Procedures (GAAP). Development of international markets leads to financial globalization of the Russian economy. Increasingly large Russian banks in Exit the global capital markets, attract foreign investment or looking for foreign investors. In order to do this, one must generate financial statements in accordance with international or other foreign standards. Particular interest is attached to the study of the experience of the formation of the system of accounting and reporting, both at national and international levels are not. Thus, banks get easier access to world capital markets and reduced the cost of its involvement, as well as investors get the reduced risks of misreporting by companies.

4. Diversification of banking risks is important in the risk management process. It involves not only dispersed ix activities in the field of active operations in various areas, as discussed above, but also conduct limiting operations and syndicated lending based on, and compliance with mandatory standards of the Bank of Russia, regulating the maximum risk.

5. Conclusion

Universal tool for solving problems in any industry is to improve the quality of governance in it. This directly applies to the banking sector, especially the banking risk management. It is important to track the risk on a regular basis, which

increases the effectiveness of decisions and allows estimating the risk dynamics. It is required to note that if one does not carry out a risk assessment on an ongoing basis, the banking system will eventually come to a crisis, as participants in the system goals are consistent with the objectives of the system as a whole.

The modern methods of assessment of banking risks include as follows:

1) The method of expert evaluations (when the risk assessment is done by professionals in various fields and areas of the economy), the concept of value at risk VaR (value at risk) - VaR-method is based on an analysis of the largest deviation from expectation calculated with some degree of probability. VaR (VaR) indicates the maximum possible loss of value of the portfolio and assets Changes that may occur during this period with the specified probability of its occurrence. More simply, the value of VaR is assurance by *X%* (with probability *X)*, which losses will not exceed *Y* rubles during *N* following days. The *Y* value is the desired value of VaR, the analytical method (used by all sorts of ways to assess the level of risk);

2) The method of historical simulation is a method of simulation modelling. Seeking profit and loss distribution is empirically. Preliminary, portfolio tools costs should be presented as a function of market risk factors, i.e., basic prices and interest rates, which affect the value of the portfolio;

3) The method of Monte-Carlo simulation refers to the methods of simulation and because it has a number of similarities with the method of historical simulation. The main difference is that in the Monte Carlo simulation is not performed using the actual observed values of factors of the market. Instead, the selected statistical distribution (normal or Student distribution), on the basis that generates thousands or tens of thousands of de hypothetical sets of values of market factors. The obtained values are used to calculate the profits and losses caused by changes in the value of the portfolio; scenario analysis (based on stress testing) is a method of predicting the highly qualified experts of several possible scenarios and the related dynamics of the main indicators of the portfolio.

The basis of each scenario is constituted by the expert hypotheses about the direction and magnitude of changes in market factors such value of the portfolio as a percentage rates, exchange rates, prices of stocks and commodities and so on at the projection period. Then, in accordance with the assumptions, a usual revaluation of the portfolio is made. The resulting measurement of stand on and will be the assessment of potential losses. The scenario approach is implemented in the testing procedure for the portfolio on the stability (stress testing). Stress testing is one of the analytical tools to both sintered assess the potential losses of credit institutions in the event of a possible recession in the economy and the statistical method. Probabilistic and statistical approaches to estimating risks suggest using criteria for assessing in the form of the random variables, such as expectation, median, quantiles, variance, mean square deviation of and others. These indicators are determined by the distribution function of the random damage, appropriate to the risk. At practical using of this approach, these characteristics are evaluated by statistical information. They are measured at the sample of observed loss values.

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