Editorial

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Catarina Figueira is Senior Lecturer in Applied Economics and Director of the Executive MBA programme at Cranfield School of Management. She was previously a Robert Schuman Scholar at the Scientific and Technological Options Assessment Division at the European Parliament. Her research interests lie in the area of financial modelling, particularly related to international financial integration, banking efficiency and regulation and housing markets. She has published in leading international journals and is a frequent contributor to a wide range of international conferences. She has advised the OECD and the European Commission on regulation and a number of financial institutions on the UK housing market. She is the editor of the Cranfield Management Research Paper Series.

The theme of this special issue is the financial services industry's emerging challenges and prospects. Over the last few decades there have been substantial changes in the industry. Recent advances in policy-making, regulatory framework, information and communication technology and risk management practices all combined with the explosive growth in the volume of cross-border capital flows have led to an increasing demand for effective, efficient and prudent deployment of economic capital. Nonetheless, as recent events have shown, inefficient decision-making and imprudent management have created unprecedented gloomy conditions in certain parts of the industry and the

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negative impacts of these are now being felt across all aspects of business life and have spread across the wider economy. Some of the papers in this special issue raise important questions as regards some of the industry's practices and previously adopted policies.

The first paper, by Sharma et al., addresses the challenges faced by existing UK banks in maintaining the regulatory risk-based capital requirements of Basel II standards. Using a sample of UK banks, the study provides evidence that in the post-2004 period all the examined UK institutions maintained an average capital ratio in excess of the 8% ratio required for compliance with the Basel II standards. These initial results are generally supportive of the findings of Ediz et al. (1999) while any effort to explain such practice should concentrate on the need of the UK banks to meet not only Basel II but the additional requirements in minimum capital required by the FSA. Nonetheless, further analysis reveals some interesting findings relating to the approach adopted by these financial institutions in managing their capital requirements. In contrast to earlier studies, Sharma et al. argue that banks on average tend not to reduce exposure to risky assets when their capital ratios are close to the regulatory minimum but rather they appear to consistently increase their holdings of these risky assets alongside increases in capital charges. The authors reach the conclusion that this widely adopted practice creates further shortfalls in banks' capital reserves while, in certain cases, some banks are found to be keener to restore these capital reserves back up to the required level through equity issuance rather than by risky assets substitution. Given the recent events in the banking sector, these results should not surprise us. The fast-expansion strategy adopted by certain banks in the pre-2007 period was facilitated mostly by regular capital borrowing in the money markets and infrequent equity issuance in the form of rights issues. However, following the subsequent deflation of the previously acquired toxic assets held in the balance sheets of most UK banks, the use of rights issues appears to be the only way possible to recapitalise themselves.

The impact of capital adequacy ratio requirements on managerial behaviour and especially earnings management is Morphi's subject in the second contribution. This paper provides a theoretical overview of earnings management and demonstrates how bank regulation, in the form of minimum capital standards, provides agents with an incentive to maximise earnings as a means to avoid the violation of such standards. As the author suggests, the inclusion of retained earnings in the regulatory capital aspect of the capital adequacy ratio gives an incentive for agents to manage those earnings upwards. Despite that, the introduction of the Basel II Accord has successfully limited the use of accruals and non-recurring items as a means to manage the capital adequacy ratio, *e.g. through the manipulation of loan loss provisions and securities gains and losses*; as the author suggests, more work is required from banking and accounting authorities to limit managerial flexibility in the case of those securities which are model-based and whose outputs can be subjected to manipulation. Morphi concludes that the sector is in need of high-quality standards that will ensure prudent and realistic reporting of all assets, liabilities, profits and losses as well as capital. It is therefore suggested that the Basel Committee should re-assess the problem of non-transparent financial information, while cooperation with accounting and auditing bodies would assist in the promotion of high-quality standards and improve prudence and stewardship in the banking sector.

A different but equally important aspect of financial intermediation is the subject examined in the third paper by Ezeoha and Amaeshi. This paper examines the impact of recent developments in the banking system in Nigeria and its lending practices to small businesses. Nigeria is a good example of an emerging economy that has experienced

and continues to undergo a major re-structuring of its banking sector. As the authors demonstrate, the development of the banking industry in this African country has had, to a certain extent, a detrimental effect on minority lending as the changes that have been taking place appear to be mainly focused on the promotion of consolidation of the industry, as well as increased bank capitalisation.

Ezeoha and Amaeshi suggest that these findings corroborate prior evidence that development approaches such as those adopted by the Nigerian government inevitably suppress credit facilities to small- and medium-size companies and other marginal borrowers. This comes in direct contrast to some of the theoretical claims by past Nigerian governments and the industry's regulatory bodies that have promoted these developments since 1952 and over-emphasised their benefits.

Amongst different but equally competing hypotheses, the more plausible explanation for such a negative relationship is the high level of information asymmetry and the risks associated with such lending decisions. Additionally, in line with the expectation theory, the study reports a positive relationship between interest rates/inflation rates and minority lending. This indicates that much of the lending to minority sectors was mostly facilitated by liberal banking policies rather than governmental structural policies. Hence, as Ezeoha and Amaeshi conclude, in terms of policing making, governments should strive to adopt effective monetary policy management as a means to improve such lending practices rather than continue current marginally efficient practices.

The impact of deregulation, globalisation and advances in information technology on the Indian banking sector is examined by Sreeramulu et al. Similar to other emerging economies, India has undergone a period of financial liberalisation aimed at reducing banking inefficiency, strengthening competition and improving banking service. According to the results, Indian banks in the post-2004 period have demonstrated a substantial improvement in their operating efficiency. Based on stochastic frontier analysis, the overall mean efficiency of Indian banks has almost doubled compared to years prior to 2004. As Sreeramulu et al. suggest, the employee cost appears to be the dominant input factor in determining the output of the Indian banking sector. In terms of ownership efficiency, according to the authors, a comparison amongst the three ownership-type groups (a) public, (b) private and (c) foreign banks highlights significant differences with the average efficiency of public sector banks improving in excess of 100%, while their private counterparts appear to be the most efficient in generating total business income. Further examination reveals that this improvement in efficiency is mostly driven by the new generation private-sector banks, giving further evidence of a successful implementation of the government-adopted financial liberalisation policies in India.

The following paper in this special issue is by Sensarma and Jayadev and is also concerned with scale and profit efficiency in the Indian banking sector. This study focuses on the efficiency generated by merger activity, filling an important gap in the current literature on emerging markets banking reforms. As the economic theory suggests, mergers driven by operational and financial synergetic effects should increase the present value of future incremental benefits maximising shareholders' wealth. Prior evidence in developed and emerging economies demonstrates that, on average, post-event performances fail to materialise the expectations of the bidding companies with subsequent deterioration of shareholders' wealth. These results are substantiated in the present study. As Sensarma and Jayadev show, despite the expectation that a forced merger of Indian public sector banks would result in substantial cost reduction, the

evidence suggests otherwise. In the period immediately following the merger, any improvements in profit efficiency or cost control fail to materialise, unless the forced merger is immediately followed by the rationalisation of the banks' branch networks. Even in such cases, costs savings are asymmetric with larger savings reported for smaller banks and vice versa. As regards the creation of shareholders' wealth in the post-merger period, the study also suggests that in certain cases of forced mergers, shareholders of both the bidder and target companies will see their wealth eroding while, in cases of voluntary bank mergers, the bidder's shareholders incur losses and those of the target register gains. These findings corroborate previous evidence on M&A activity and raise important policy-making questions on the purpose and efficacy of such business activities. In addition, the implications extend beyond the area of banking and financial services and affect fields such as law, risk management and corporate governance among others. Hence, it would be interesting to see more multidisciplinary research aimed at addressing the complex relationship of such theoretical concepts and their applied aspects within different frameworks and alternative conditions.

The last paper of this special issue from Figueira et al. deals with the effects of the Asian financial crisis on the performance of banks in the South-East Asia. According to the authors, the sampled banks' performance worsened in the post-Asian crisis period as well as there was an increase in the non-performing loan provisions to total assets ratio for all these banks. This higher non-performing loan to total assets ratio is a signal of higher risk and is negatively associated with bank profits. The findings also suggest that foreign banks, possessing global advantage, are more cost efficient than domestic banks in developed countries, while domestic banks, possessing home-field advantage, appeared to be more cost efficient than their foreign counterparts in the case of developing countries. This pattern of home-field advantage appeared to be stable over time. Finally, the pattern of global advantage changed, with no global advantage for foreign banks reported after the recovery from the financial crisis.

As editors of this issue, we would like to thank all the authors who have contributed and all the anonymous referees whose advice assisted the authors in improving their work. Our final expression of gratitude goes to all the people that have helped in the completion of this issue and whose support gives us the opportunity to raise important questions that aim to promote and trigger a fruitful and highly stimulating academic debate.