Editorial

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The current Special Issue ‘In the Grip of the Credit Crunch: Challenges of Confronting a Changing Environment’ has been prompted by the recent credit crisis that has fundamentally changed the landscape of financial services. These changes have posed new questions for academics and practitioners – questions related to the analysis of processes and factors leading to the crisis, such as financial market regulation and general economic policies, flaws in business models/strategies, risk management deficiencies, sales-oriented remuneration.

I am pleased to present a truly interdisciplinary collection of papers that provide insights into some of the questions brought to the fore in different segments of financial markets.

The issue opens with a contribution from Bellotti that explores possible inaccuracies in estimation of credit risk. Over-reliance on risk prediction models has been viewed as one of the reasons leading to the crisis. The paper examines two risk management approaches that are commonly used in banking: credit scoring and Value at Risk (VaR) models. Credit scoring models provide estimates of the default probability that are employed to accept or reject credit applicants in retail banking. These estimates can be used to form groups of accounts, each representing a different level of risk. Such risk groups appear to have little overlap between them, and therefore seem to offer a good indication of risk. Yet when one moves from using only the default probability to considering other risk elements, such as model estimation uncertainty, exposure at default and loss given default, risk discrimination becomes less clear. By applying computer simulation

to a portfolio of 50 000 credit cards, Bellotti demonstrates how the distribution of expected losses changes with each new risk element added. The paper also shows how VaR models can underestimate extreme credit risk, when important risk elements are omitted from the analysis. The conclusions present an important message to risk analysts and decision makers who rely on risk prediction models.

The paper by Yeh continues the topic of loss estimation by investigating the efficiency of provisions for bad loans made by Taiwanese banks between 1997 and 2004. Real loan loss provisions (LLP) may differ from those officially reported by the banks. Bank managers might be tempted to report lower expected losses in order to create better impression on investors. By estimating a stochastic LLP efficiency frontier, the paper creates the benchmark that is used to compare the reported LLPs of individual banks. Deviations from the estimated frontier signal the bank’s inefficiency. The paper argues that there is evidence suggesting the inefficiency of LLPs by Taiwanese banks during the period examined. The paper confirms that provisions are positively correlated with the default loan losses. Larger banks are found to be more efficient than smaller banks. This is attributed to the fact that larger banks are more concerned with credibility of their reports. Higher non-interest expenditure is associated with higher inefficiency in LLP decision making.

Among various adverse effects of the recent crisis, a particular concern has been expressed about a possible impact on small and medium enterprises (SMEs). This is not surprising, given an important role SMEs play in economic development. The third paper

by Ma and Lin explores the situation in the United Kingdom by reviewing the cases of SME problems reported in mass media. The authors suggest that problems are owing to recessionary conditions that have reduced the demand, and affected the rate of payments. Financial institutions are encouraged to increase credit to SMEs, but at the same time they need to adhere to conservative prudent lending. Certain segments within SME market may be perceived as being higher risk by financial institutions, and this would be reflected in credit restrictions and higher credit costs. The paper goes on to explore the academic literature on factors related to bankruptcy/survival of SMEs, and therefore, their risk. A wide range of papers are reviewed that look into a variety of countries and industries. The summary of factors affecting SME survival would be of value to both academics and practitioners working in the area of SMEs as a succinct picture of risk-related aspects.

The theme is further elaborated by Lugovskaya, who offers exactly a kind of study that has been reviewed by the previous paper. Lugovskaya investigates prediction of default (defined as a legal bankruptcy) for SMEs in Russia. Two linear discriminant analysis models have been developed using a sample of 8967 businesses compiled from two public sources on SME performance in Russia. The first model includes financial ratios as bankruptcy predictors, the second business model investigates the additional value of size and age variables. Liquidity and profitability measures are found to be the most predictive ones among the financial ratios. The addition of size and age does not produce a definitive improvement in the model's predictive ability. While the second model has a smaller Type II error (that is incorrectly classifying healthy company as a bankrupt one), Type I error is higher (misclassifying bankrupt as healthy) as compared to the first model. The study by Lugovskaya fills in a gap in literature, as research into default of the Russian SMEs

has been scarce. It is also important as an illustration of the potential of statistical modelling, which is yet to be adopted by Russian banks in lending to SMEs.

The next paper by Gklezakou and Mylonakis provides an investigation of interdependence of US, European and Japanese stock markets. The specific research question is whether interdependence changes in conditions of severe credit crisis. The analysis has been performed using daily prices of 10 stock market indices between 1 January 2000 and 20 February 2009. The methodology involves correlation analysis that determines whether the relationship exists, and Granger causality tests that suggest the direction of influence. The results of the analysis indicate that the crisis increases the correlation between different markets, with the direction of influence being affected too. The authors demonstrate that in accordance with previous research, Dow Jones in USA (DJ) and German Stock Index (DAX) have dominated other indices up to 2007 irrespective of bull or bear market conditions. However, under the crisis conditions these two indices no longer show the dominant influence.

The Special Issue concludes with the contribution by Norton that draws on lessons learned from history. An important feature of the latest crisis consists of the fact that very few experts were able to see it approaching, nor could anticipate its severity. The paper investigates the causes of the 1920's 'credit crunch' and the Great Depression in the United States and draws parallels with the recent situation. An extensive analysis of previous literature on legislative responses by the US government in 1920s highlights the features relevant in present circumstances. The paper considers proposals for the reform of the banking system suggested by policymakers, such as tightening on capital adequacy and restoring relationship lending. In light of the analysis, the implications for marketing strategies are evaluated. The paper calls

for greater focus on promoting trust and transparency between banks and their stakeholders and in bank-to-bank interactions.

I hope that you enjoy a range of contributions for this Special Issue on credit crunch and its effects on financial markets and find them insightful, stimulating and thought provoking. As a guest editor,

I would like to express my thanks to the authors and the academic referees for their dedication and hard work.

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