CHAPTER 3

AN OVERVIEW OF THE MERCHANT BANKING INDUSTRY

The Merchant Banking Industry : A Historical Perspective

There is a certain exotic ring to the term 'merchant bank[1] '. It has been said to conjure visions of power and influence. Indeed, the Six Great Powers of Europe in the late nineteenth century were listed as England, France, Russia, Austria, Prussia and Baring Brothers respectively (Emden, P.H., 1946). At this time, of course, we know what goes round comes around.

What then is merchant banking? The term "merchant banking" originated in the 18th century to describe European Banking groups or families such as the Barings (now infamous) or Rothschilds who pioneered various facets of trade finance and foreign exchange for the rapidly emerging industrial concerns of the era. Merchant banking activities have its origins in London when the Empire dominated

[1] "The term 'merchant bank' is sometimes applied to banks who are not merchants, sometimes to merchants who are not banks and sometimes to houses who are neither merchants nor banks"- Sir Edward Reid: 'The Role of the Merchant Banks Today' being the Presidential Address to The Institute of Bankers, 15 May 1963.

international trade in the late eighteenth century. There were many London merchants then who dealt in international trade dealing in primary commodities such as rubber and cotton. At this point, the merchants were merely financing their own trading activities. As international trade grew, they realised that commission stands to be made if they 'lent' their names to commercial bills issued by lesser-known merchants. They endorse and guarantee payments of other companies' bill of exchange by agreeing to accept them on their behalf. Hence, the bills became more readily accepted by others and therefore became negotiable. Thus, grew a business of accepting bills to finance the trade not merely of themselves, but of other merchants. However, the capacity to accept these commercial bills required specialized knowledge of the financial position and the business nature of the merchants who issued the bills. Through time, the evolution of a new type of financial institution known as a merchant bank took place.

Another historical characteristic of the merchant banks was the raising of capital for foreign governments. These were in the form of bonds issued in the London. (Hanson, 1979) Thus, there are accepting houses and issuing houses, and most of the leading merchant banks are in both categories. However, merchant banks were also active in providing investment advice and management of funds. Hanson pointed out two particular characteristics usually attributed to merchant bankers. They are a) their entrepreneurial instinct, borne out by their merchanting days and their inclination towards risk in their handling of loans which they would take to their own books before placing them with the public; and b) their adaptability and creativity, borne by their ability to adjust to changing circumstances over the years.

As England lost its ground as the world's leading economy, merchant banks in London, turned to providing banking services for local companies. These include moving into the field of corporate finance, issuing and underwriting share capital and other financing services. There were also those who specialize in management of investment portfolios, unit trusts, insurance broking and pension fund management. Indeed all that unites them is that they all serve primarily, though not exclusively, the corporate sector. Merchant banks in London are now seldom merchants and by no means always bankers.

Deregulation and globalisation have rendered the term overlaid with international variations. The French banque d'affaires and the American investment bank are recognisably cousins of the English merchant bank. C.J.J.Clay and B.S.Wheble (1983) defined the merchant bank in the City of London context as the 56 members of the Issuing Houses Association, which include the 16 members of the Accepting Houses Committee. The two entities above have now been replaced by the British Merchant Banking and Securities Houses Association in 1988.

Michael T. Skully (1983) felt that the functional definition of a merchant bank as a corporate entity that act in the money market and wholesale banking, underwriting and corporate advisory work, international finance and investment management; has its limitations as commercial banks perform similar functions. He further proposes that a merchant bank has the following characteristics as an organizational requirement, or one based on the bank's attitude to business :-

1. High proportion of professionals to total staff

2. A substantial delegation of decision making

3. A short chain of command

4. Rapid decision making

5. Flexible organization structure

6. Innovative approaches to problem-solving; and

7. High level of financial sophistication

The Malaysian Merchant Banking Industry

Merchant banks in Malaysia have little to do with merchant banking in London. In fact, merchant banks in Malaysia are very much the recent creation of the Central Bank.

The idea of having merchant banks in Malaysia first came up in 1968. It was originally mooted by Tun Ismail Mohamed Ali who was Governor of Bank Negara Malaysia from 1962 to 1980. He discovered a need for merchant banks in Malaysia after Bank Negara helped to organize and put together a number of family companies who wanted to diversify and expand. With Bank Negara's help, they became a holding company with subsidiaries and issued shares to the public. The Central Bank had done all this without a fee. He rationalizes further that there were many traditional family businesses then involved in trade and property that wanted to diversify into industry. Therefore, there was a pressing need for an advisor who can help companies to reorganize to mobilize sufficient capital and expertise. Tun Ismail also saw a role for merchant banks in restructuring ailing companies (Singh, 1984). In short, the original role for merchant banks were to supply technical financial expertise necessary for national development and to fill the gap in financial services within the domestic economy. The need for such services grew even more during the New Economic Policy (NEP) era after 1971 as companies were encouraged to restructure their equity ownership. The local merchant banks played an important role in the implementation of the NEP in the 1970s.

Malaysia's first merchant bank, Chartered Merchant Bankers (Malaysia) Bhd (now Permata Merchant Bank Bhd) was established in 1970 while the latest merchant bank licence was issued to BSN Merchant Bank Bhd on 1 August, 1995. The licence was granted as BSN Merchant Bank Bhd had acquired the entire operations of the insolvent Rakyat Merchant Bankers Bhd pursuant to a Vesting Order issued by the High Court on 22 July, 1995. As such, the number of merchant banks remain unchanged at twelve since 1976. Basically, the Government is of the view that twelve merchant banks are sufficient to serve the merchant banking needs of the corporate sector. Only three merchant banks operate branch offices outside Kuala Lumpur, one (AMMB) of which has four branch offices in Johor Bahru, Kota Kinabalu, Kuching and Georgetown while the remaining two merchant banks (MIMB & Utama Wardley Bhd) operate a branch office each in Penang and Kuching respectively. Table 2.1 shows the chronological establishment of merchant banks in Malaysia.

Table 2.1 : The Establishment of Malaysian Merchant Banks

Year	Number of new merchant banks which commenced business
1970	1
1971	1
1972	1
1973	2
1974	3
1975	3
1976	1
1995	1*
	12*

Source : M.T. Skully (1983)
N.B. : *Bank Negara Malaysia has assumed control of the insolvent Rakyat Merchant Bankers Berhad on 3 March ,1994 and subsequent to the end of the financial year, BSN Merchant Bank Berhad has acquired the entire operations of the said insolevnt bank pursuant to a Vesting Order issued by the High Court on 22 July, 1995.

A common feature to all merchant banks in Malaysia is that in their formative years, each of the merchant banks had at least an established international bank of reputable financial institution abroad as its shareholder. The obvious reason was that the merchant banks would have access to both the financial expertise and international affiliations necessary to effectively support their advisory and financial roles. Table 2.2 shows a list of Malaysian Merchant Banks and their respective shareholders.

Table 2.2 : A List Of Malaysian Merchant Banks And Their Respective Shareholders (as at 15 November 1995)

Amanah Merchant Bank Bhd

owned by:

Kompleks Kewangan Malaysia Berhad (74.2%)
The Mitsubishi Bank Ltd (20.0%)
Mitsubishi Finance (Hong Kong) Ltd. (5.8%)

Arab-Malaysian Merchant Bank Bhd

owned by:

AMMB Holdings Berhad (100%)

Aseambankers Merchant Bank Bhd

owned by:

Malayan Banking Berhad (70.45%)
Union Bank of Switzerland (5.0%)
Dresdner Bank AG (5.0%)
The Dai-Ichi Kangyo Bank, Ltd. (5.0%)
Klienwort Benson Ltd. (5.0%)
Banque Paribas (5.0%)
Sarawak Foundation (4.55%)

Asian International Merchant Bank Bhd

owned by:

United Malayan Banking Corp. Berhad (51%)
Fuji Bank Ltd. (15%)
Tun Omar Yoke Lin Ong (3.75%)
Toh Puan Aishah Ong (3.75%)
A&Z Grindlays Bank (26.5%)

Bumiputra Merchant Bankers Bhd

owned by:

Bank Bumiputra Malaysia Berhad (77.5%)
MN Rothschild & Sons Ltd (15%)
The Bank of Tokyo Ltd (7.5%)

Commerce International Merchant Bankers Bhd

owned by:

Commerce Asset-Holding Berhad (64%)
Bank Pertanian Malaysia (20%)
The Sanwa Bank Ltd. (16%)

DCB Sakura Merchant Bankers Bhd

owned by:

DCB Bank Berhad (70%)
The Sakura Bank Ltd (20%)

The Sakura Finance Asia Ltd (10%)

Perdana Merchant Bankers Bhd
owned by:
United Merchant Group Berhad (70.1%)
Hong Leong Credit Berhad (29.9%)

Malaysia International Merchant Bankers Bhd
owned by:
Malaysian Industrial Development Finance Berhad (70%)
Barclays Bank PLC (20%)
Barclays Finance Holdings (Asia) Ltd. (10%)

Permata Merchant Bank Bhd
owned by:
Affin Holdings Berhad (60%)
Malaysian International Shipping Corporation Berhad (35%)
Koperasi Pegawai-pegawai Melayu Berhad (5%)

BSN Merchant Bank Bhd (formerly Rakyat Merchant Bankers Bhd)
owned by:
Bank Simpanan Nasional Berhad (98%)
Dato Mohd Kasa b. Abdul Aziz (1%)
En Mohd Ariffin Marzuki (1%)

Utama Wardley Bhd
owned by:
BUMB Holding Berhad (76%)
HSBC Investment Bank Asia Holdings Ltd. (20%)
The Industrial Bank of Japan Ltd. (4%)

Source : Association Of Merchant Banks Malaysia

As stated earlier, merchant banks were to fulfil the growing need for specialised financial services. They are financial intermediaries who complements and supplements financial services offering specialized expertise in money and capital markets. It follows that merchant banks are regarded as "wholesalers" as they deal primarily with corporations and try to cater to their every financial needs. By contrast, commercial banks and finance companies are "retail" in nature. Hence, the services uniquely provided by merchant banks generally reflect the objectives for which they were formed and these can be divided into five main categories which include :

(1) Corporate advisory services in relation to mergers and acquisitions, reconstructions or capital restructuring, company listings on the Kuala Lumpur Stock Exchange, rights issues, issues of private debt securities and equity-linked debt instruments such as bonds with warrants and convertible loan stocks, underwriting of corporate securities, private placements and joint-venture promotions, independent and minority advice, Special Bumiputra Issues, Employee Share Options Schemes and share valuations, privatization and consultancy services with regards to privatization studies, advice on equity or investment in new and on-going projects, project appraisal and project feasibility studies, leveraged and management buy-outs, corporate and financial planning; and management consulting and research.

(2) Corporate banking services entails arranging and extending credit facilities to corporate borrowers to meet their financial requirements The scope of services under this category include extension of short, medium and long term loans, Bridging loans, Syndicated Credit facilities, managing and underwriting issues of Private Debt Securities such as Bonds, Notes Issuance Facilities (NIFs) and Revolving Underwriting Facilities (RUFs), Structured Financing, Project Financing, International Finance and Off-shore loans, Issue of Bank Guarantees, Bankers Acceptance Facilities, Bills and Invoice Discounting, Block Discounting and general financial advisory services.

(3) Treasury and money market services as in acceptance of term deposits, inter-bank deposits and payments, short term repurchase agreements (Repos) and the primary and secondary trading as principal dealer of Bankers Acceptances (BA), Bank Negara Bills, Cagamas Bonds and Notes, Malaysian Government Securities, Negotiable Instruments of Deposit, Treasury Bills and Private Debt Securities.

(4) Investment and securities services such as portfolio and asset management, custodial and settlement of stocks and shares, nominee services including custodianship of all type of securities, research, establishment of unit trusts and other financial management advisory services.

(5) Other related activities such as promotion of new financial investments and products, product development, diversifications, joint-ventures including assisting customers to find suitable partners or investors, international financing; and venture capital financing.

Presently, merchant banks in Malaysia are licensed under the Banking and Financial Institutions Act 1989 (BAFIA 1989) and they operate under the supervision of Bank Negara Malaysia. Initially. during the 70s, they were formed as public limited companies under the Companies Act 1965. Their activities were not regulated by any specific piece of legislation except for operational guidelines as advised by Bank Negara Malaysia. From 1 January, 1979 the merchant banks were bought under the ambit of the Banking Act 1973. The Banking Act 1973 was subsequently repealed and replaced by the BAFIA 1989 which came into force on 1 October, 1989.

The BAFIA 1989 provides a comprehensive legal framework for the licensing and regulation of merchant banks, together with other banking institutions. 'Merchant banking business' is defined by the BAFIA 1989 as the business of not only receiving deposits on deposit account and providing finance but also providing consultancy and advisory services relating to corporate and investment matters or making or managing investments on behalf of any person. The main functions of merchant banks, however are concentrated on basically fee-based services which must constitute at least 30% of their annual income. This is still required, as a matter of policy, although the new licenses issued under the BAFIA 1989 do not contain the above condition specifically.

In essence, the operations of merchant banks are governed by:

1) Statutory or legal framework
2) Guidelines for Financial Institutions
3) Other Operational Guidelines

The more pertinent requirements to be complied by merchant banks under the legal framework and/or guidelines are :

1. Merchant banks must have a minimum paid-up capital unimpaired by losses, of not less than five million ringgit.

2. Merchant banks are required to observe a capital adequacy ratio of minimum of 8% (of which the core capital element should be at least 4%) of the bank's weighted risk assets.
3. Merchant banks are to maintain with Bank Negara Malaysia a liquidity reserve of 10.0% (and 12.5% for merchant banks which are allowed to issue NCDs) and statutory reserve of 8.5% of their total eligible liabilities.
4. Credit facilities granted to a single customer shall not exceed 30% of the merchant banks capital funds. In addition, the aggregate amount of "large" loans (equivalent to 15% or more of the bank's capital funds) shall not exceed 50% of the bank's total credit facilities. As for loans secured by shares, such loans shall not exceed 25% of the bank's total credit facilities. Besides extending credit facilities predominantly in ringgit, merchant banks are also allowed to grant loans in foreign currencies to residents for the financing of ventures to raise domestic productive capaciy and to support the purchase of assets in Malaysia owned by non-residents.
5. The minimum denomination of deposits that merchant banks are allowed to accept from associations, clubs and foundations was reduced from RM1million to RM500,000, while the minimum denomination for deposits from banking institutions and approved financial institutions remain at RM250,000. Merchant banks are also allowed to accept fixed deposits from all corporations, associations, clubs, foundations, trust companies, trust funds and pension funds, subject to the stipulated minimum tenure year of one month and the minimum amount of RM200,000.
6. Investment in manufacturing companies, and of trustee and permissible non-trustee shares specifically approved by the Central Bank are allowed pursuant to the

Banking and Financial Institutions (Acquisition and Holding of Shares and Interest in Shares) (Licensed Banks, Licensed Finance Companies and Licensed Merchant Banks) Regulations 1991. However the aggregate value at cost of all investment in these corporation should not exceed 25% of a merchant bank's paid-up capital and published reserves.

7. Further, the merchant banks are allowed under the 1991 Regulations to hold interest in shares e.g. equity derivatives, such as transferable subscription rights, stock options and stock warrants.

8. Debt-equity swaps are also allowed as according to specific Central Bank guidelines. This is to enlarge the number of viable alternatives available to package a workable corporate restructuring plan to resuscitate problem borrowers.

9. Merchant banks are also allowed to underwrite or sub-underwrite foreign securities with the prior approval of the Central Bank. The amount involved should not exceed 10% of the total issue or 10% of a merchant bank's paid-up capital and published reserves, whichever is lower. In aggregate, the amount of foreign securities underwritten by a merchant bank should not, at any one time, exceed 25% of its paid-up capital and published reserves.

A more comprehensive treatment of other regulations and guidelines governing the operations of merchant banks are appended in Appendix A.

Merchant banks are more in the role as younger brothers as it is the commercial banks which carry the greater weight of responsibility. Commercial banks account for the largest proportion of the assets of the financial system, the merchant banks for the smallest. It has never been disputed that the merchant banks were once laggards of Malaysian banking but this is no longer true. In the three years to 1994 their total income rose by 42% and their profits rose by 114%. By comparison, the commercial banks' incomes rose by half that rate, and their profits by a respectable but lesser 90%. The merchant banks' 1994 pre-tax profits made up 10% of the banking system's $4.8 billion profits; three years earlier the figure was only 8%.(Bank Negara Malaysia, 1995). According to the Minister of Finance, total resources of domestic merchant banks grew 12% to RM23.9 billion as at 30 Sept 1995, which although considered high by international standards, was a sharp drop from the 24.7% growth in the same period in 1994. Total deposits remained the dominant source of funds. For the first 9 months of 1995, total deposit grew 15.8% to RM16.4 billion compared to 10.1% previously. Total loans grew 10.1% to RM 12.1 billion versus 25.2% before.(The Sun, 12 Dec 1995)

Association of Merchant Banks in Malaysia

The 12 merchant banks in Malaysia are members of the Association of Merchant Banks in Malaysia (AMBM). The umbrella body was formed on 9 September, 1975. The objectives of the representative body are:-

1. To represent the interests of the members in Malaysia in cooperation and consultation with Bank Negara and any other relevant authorities;

2. To make representation to the Government or to any person or body in Malaysia about any matters affecting the business of merchant banking in Malaysia bearing in mind the objectivesof the national economic policy;

3. To promote sound practices in the conduct of merchant banking business; and

4. Act as a vehicle for greater rapport with associations of financial institutions.

Presently, the Association has bi-monthly meetings to discuss and decide on matters of common interest and the industry's responses to particular issues affecting the industry. The activities of the association is led by the main committee which comprises 2 representatives from each merchant bank. The main committee's work is complemented by various sub-committees.

AMBM, for the moment has not laid down any rules and regulations on the workings of merchant banks. The association does formulate certain policy guidelines e.g. a minimum accord on corporate advisory fees and practice notes on treatment of service tax on services provided by merchant banks. This is envisaged to change in the future as the trend is towards self -regulation in the face of growing professionalism, uniformity and the need to protect market share.

The Worldwide Merchant Banking Industry

The world of finance is synonymous with Wall Street. In the United States, both state and federal laws including the Glass-Stegall Act enforced a sharp separation between institutions collecting deposits and making loans with entities permitted to own equity interests or offer underwriting services to their clients. As a result, the U.S. financial services industry grew up with distinct groups of financial firms extending credit, making equity investments, and performing underwriting or similar agency services. Commercial banks fulfilled the deposit gathering and debt role while investment banks fulfilled the underwriting and advisory roles; and individuals and institutional investors such as insurance companies, pension fund managers made most of the equity investment decisions. During the liberalisation of the banking regulations the past decade, some firms have begun to recombine several of these capabilities in certain transactions, thus bringing 'merchant banking' back to the United States.

Today, United States firms offering merchant banking capabilities fall into three categories: investment banks, commercial banks, and Leverage Buy-out (LBO) funds. Investment banks have set aside or manage funds that can be temporarily or permanently invested in transactions where the firm is providing other services as well. Depending on the firm, these funds may be invested in situations where the investment bank is acting in fee-advisory roles. They may also be invested in situations that have no other connection with the investment bank. Theoretically, the commercial bank's ability to provide debt coupled with their affiliated venture capital or merchant banking arms could make them powerhouses among merchant bankers. Several large commercial banks have established successful investment banking advisory capabilities that enable them to compete with the investment banks for acquisition, divestiture, restructuring, or other forms of advice. Examples are Citicorp, Bank of America and Banker's Trust. LBO funds are active investors who not only make investment decisions but also actively seek transactions, design acceptable capital structures, and arrange for any portion of the debt and/or equity financing not provided from funds under their management. For such services, these firms charge a 'transaction fee' that is effectively paid out of the financing arranged.

The dominant role played by the U.S. firms cannot be denied. As reported in The Asian Wall Street Journal (8 January 1996), seven of the top 10 merger advisors worldwide are American, and two others are partly American-owned firms. The top four global underwriters of stock offerings in the past three years have also been American firms. This is due to professional skills, cross border networks, innovativeness, cultural advantages, experience, technological superiority and sheer capital size.

However, European merchant banks are trying to break up Wall Street's oligopoly with large commercial banks moving into merchant banking by buying out competitors, building distribution networks in the U.S., and opening new offices in emerging markets around the world. For example, Germany's Dresdner Bank acquired Britain's Kleinwort Benson for US$1.5 billion, rival Deutsche bank consolidated global merchant banking unit in London with Morgan Grenfell while Holland's ING Group took over Barings.(Business Week, 2 Oct 1995)

The Merchant Banking Industry in the ASEAN

M.T. Skully (1983) outlines the development of merchant banks in ASEAN countries. According to Skully, the first semblance of merchant banking activities in the ASEAN region came in the Philippines, where from 1565 to 1815 the first commercial paper in Asia , 'boletas' (certificates of paper representing cargo space allotments on the annual Manila-Acaculpo shipping convoys), was traded as a form of bearer bonds between Spanish and local merchants. By the 1800s, British and other foreign merchant houses had banking roles and operations in ASEAN trading centres. Gradually, their banking functions were replaced by commercial banks who took over their trade financing activities. Thus, when local merchant banks developed in ASEAN, their emphasis was towards underwriting and development finance.

In terms of forming a domestic merchant banking industry, Philippines took the lead in 1959 with a multitude of foreign and local joint ventures within the region. Thailand had its first private sector merchant bank in 1969, Thai Investment and Securities Co. Ltd which is also a multinational joint venture. Singapore and Malaysia followed suit in 1970 while Indonesia's merchant banking industry began to develop in 1972.

The growth of the industry in Malaysia and Indonesia has been stifled by government policy while new merchant banks have been licensed in the Philippines and Thailand to saturation point. Only Singapore with its regional outlook encourages new entries. Singapore has more than 60 merchant banks to date.

Common problems faced are when joint ventures proved unworkable and therefore, consolidations are inevitable. Overall, there have been a reduction in the average number of institutional shareholders. This has caused a further growth in the number of merchant banks as foreign bankers leave to form their own. This is very much the trend within Singapore. It is envisaged that this might happen in other ASEAN countries in the face of continued liberalisation of the financial industry and protracted prosperity in the ASEAN region.