CHAPTER ONE

INTRODUCTION

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1.1 Introduction

Finance companies in Malaysia which formed part of the financial institution started functioning in early 1960s and expanded their operational substantially to become the second largest group of deposit taking financial institution after the commercial banks.

The finance company as we known it today is largely the sector of a long term evolutionary process. The basics tenets of finance companies have been well honed over the decades and changes, generally occurs very gradually. However, with the advent of the quantum leaps in technology, and various studies which reveal the inherent inefficiencies in the finance companies, the stage set for a period of revolution. The revolution is already happening in various parts of the finance company. It will involve major changes to the basic products, the way they can be integrated, and ultimately the method and means of government regulation.

In finance company, the change is happening in a different way. In some areas , we are more advanced than some countries, but in others we are a long way behind. Due to the impact of the current regional crisis may well be that the development of our financial company has become increasingly challenging. Concepts and techniques gainfully used only a few years ago now seemed outdated.

During the past one decade or so, the business of finance companies have gone through a period of extremely rapid and accelerating changes under the combined impact of profound modifications in the economic environment, technology market forces and public policies regarding the regulatory framework.

Thus, for instance, regulatory on policy changes introduced in response to changes in the economic and financial situation of a nation have induced structural changes in the banking and finance industry which in turn have required a re-adoption of the regulatory. Therefore, the current financial turmoil is having a very significant impact on real economy and changing the structure of industries. The banks and finance companies in Malaysia confirms to be an oligopoly and is controlled by Bank Negara Malaysia. This industry is traditionally has been protected from increased foreign competition and is fragmented. The small banks and finance companies could not sustain the competitiveness of foreign owned bank and finance companies. So, if the bank regulators let the market forces to determine the performances of the banks and finance companies, the survivability of small banks and finance companies will become dilemma and will be swift away by the turbulent economic condition as experiencing now. Since the banks and finance companies are the growth engine of economic of a nation, if any imbalance of the industry will create tension and in confidence among the investors and the public. In order to sustain the confidence and strengthened the industry, the central bank encourages the banks and finance company mergers to enhance the liquidity of the banks and finance companies.

The plan to merge the finance companies has been mooted since the late 1980s but the timing and economic climate then was not conducive[1]. Finance companies are fully aware of the benefits of being strong and well capitalised. Mergers and takeovers are transforming the shape of finance activities as finance companies take up to new challenges and pressures. Mergers would seen, could be the appropriate catalyst needed for the local finance companies and enhance its position as its faces imminent liberalisation of global financial sector. There are several reason put forward to why mergers are beneficial and the main ones are the premium attached to bring a bigger entity in term of carry out cost cutting measures and deregulation. Also mergers could be the way out

[1] Bank Negara Malaysia,Internet ,Press release,January 2,1998

for finance company to consolidation in over finance companies so that finance company's failures do not occur.

1.2 Merger Plans for Finance Companies

It is seen that the structure of Malaysia's domestic finance company industry is highly fragmented, thus has resulted too many sub-scaled domestic finance companies. Being sub-scale has a number of unfortunate consequences such as higher cost, higher borrowing rates / lower deposit rates, excessive employment craving out other sectors, under investment in Information Technology (IT) and sub-optimal clustering of finance company branches. Therefore, there is a need to have fewer but bigger finance companies in Malaysia.

1.2.1. Trade Liberalisation

The driving force behind the merger plan is to prepare finance companies for the industry's liberalisation. Bank Negara has been pushing for a sweeping consolidation of the sector, especially as foreign investors will be allowed to own up to 51% of Malaysia Financial Companies in 1999, when the World Trade Organization (WTO) agreement on financial liberalisation takes effect[2] .

Hence ,mergers of financial companies are inevitable as the finance company industry is being facing the looming competition from foreign players once the industry is liberalised. As most of the banks and finance companies in this region are small, and has a quite limited resource to expand its capacity. The opening up of the financial industry following the world trade organisation agreement would cause problem for banks and finance companies to compete and sustain in the region.

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[2] Wall street Journal, December31,1997

This is because even if the banks and finance companies merged with other banks and finance companies in its own country, they may still not be able to compete in the same sector with other big foreign banks and finance companies.

The trade liberalisation of the service sector is covered under the General Agreement on Trade in Services (GATS) and falls into two broad sectors namely financial and non financial services[3]. The financial services Annex illustrate the right parties notwithstanding other provisions, to take prudential measures, including for the protection of investors deposits holders and policy holders, and to ensure the integrity and stability of the financial system. In principal Malaysia has agreed to liberalise its financial market sector to foreign companies under the agreement on national treatment commitments that contains in the respective schedules of commitments of GATS.

As said earlier, Bank Negara Malaysia has been an instrument in encouraging financial institutions to enter into mergers and strategic alliances to strengthen their position in view of the eventual liberalisation of the financial services sector. Hence, the liberalisation of the finance sector will create a new competitive environment with greater presence of foreign banks and finance companies in the country. There would be more cross-border services through the advance technology telecommunication networks system. Therefore, the size has become an increasingly important factor to gain competitiveness. So, the Malaysian financial industry becomes fully liberalised, it would face the onslaught of global competition, then the smaller and weak finance companies have to merge into bigger entities. The Central bank has warned repeatedly that the entire finance sector will need to consolidate to compete when Malaysia opens its financial businesses to greater foreign competition in a few years.

[3] Bank Negara Malaysia, Annual report 1995, Page 104-167

1.3 Two-tier of Regulatory System of Finance Company

The central to the finance mergers are the tier-1 banks and finance companies. According to Bank Negara, they would reform the 'core' and 'anchor' around which the small financial institutions would merge to form larger and stronger groups[4]. Bank Negara Malaysia and Ministry of Finance are the regulator of finance company have actively involved in the consolidation process of domestic financial institutions. They ensure that the banking and finance companies are running in a healthy manner and efficient, to insulate the economic growth of the nation. The failure banks and finance companies system that incur high cost and inefficient of capital management would be considered a wasteful and disservice to the economic future of the nation. The aim of the regulators are to create bank and finance company system are competitive, healthy, effective and efficient to provide financial support for capital and service to the customers.

Bank Negara Malaysia had introduced several measures since 1994, to foster greater competition among the financial institution sector. The two-tier regulatory system (TTRS) were introduced to ensure the financial institution is strong, efficient and well managed and penalised the inefficient. The aim is to allow the stronger financial institutions to operate in a more liberal and open financial environment. Furthermore, Bank Negara Malaysia implemented the two-tier system is to gear the finance institutions towards a greater self-regulation in the financial system.

The two-tier regulatory system (TTRS) was introduced by Bank Negara Malaysia in 1994 and was aimed at developing a core of well-managed and well-capitalised financial institutions. However, the two-tier regulatory system was extended to cover the finance companies from April 1,1996 and there are four tier-one finance companies in the country and the rest are the tier two finance

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[4] The Star, January19,1998

Companies(table 1). The system, groups the finance companies into two categories, namely, Tier-one and Tier- two based on their capital strength and performance. Presently, the Bank Negara Malaysia has reviewed the capital funds requirement for tier-one finance companies which to have minimum share holders' fund of RM 300 millions by June 1999 which would be raised to RM 600 million by end 2000. The minimum capital funds for finance companies was RM 5 million since 1994.

Apart from these quantitative measures, finance companies are seeking tier-one status have to satisfy a set of stringent qualitative criteria known as CAMEL. These are the same criteria used in the evaluation of commercial banks, and cover capital adequacy, asset quality, management efficiency, earnings performances and liquidity position. These are the fine critical components that used to evaluate finance companies operation and performance. Table one shows the tier-one finance companies key financial figures in 1997.

Under the system, finance companies which meet the eligibility criteria set by Bank Negara Malaysia(designated as Tier-one finance companies) are allowed to provide a broader range of services and operate in more liberal environment. Among these are the provision of factoring and remittance (within Malaysia) services, participation in venture capital financing and special funds established by Bank Negara Malaysia, issuance of negotiable certificates deposits(NCDs) up to five times the capital funds and granting of unsecured business loans up to a maximum of RM500,000.

Table1 : Key financial data of tier-1 Finance companies and Credit corporation(M) Berhad and EON Finance Berhad

Tier One finance company	Date tier1 Status obtained	Total assets	Share holders' fund	Loans & advances	Deposit from customers	Net interest income
Mayban finance as at 30/6/97	1/4/96	21.442b	1.448b	13.775b	12.442b	607.754m
Public finance As at 30/6/97	1/4/96	9.299b	777.845m	6.168b	7.151b	163.540m*
Hong Leong Finance (as at 30/9/97	1/9/96	8.189b	466.201m	5.461b	6.658b	232.029m
Arab M'sian finance As at 30/9/97	9/7/97	18.726b	949.124m	13.502b	7.220b	289.778m
CCM As at 30/9/97	-	7.315b	416.906m	4.317b	4.186b	103.823m*
EON Finance As at 30/6/97	-	3.286b	381.515m	2.550b	1.905b	63.171m*

Source : BNM * Half yearly figures

1.4 Consolidation of Finance Company

As part of the strategy to strengthen the banking system, Bank Negara Malaysia initiated the merger of finance companies to accelerate the consolidation of the finance company industry. This was to reduce the number of finance companies, making them larger, stronger and more capable of enjoying economic of scale. The consolidation exercise will be effected in the following forms :

i. mergers of smaller finance companies with the six identified anchor finance companies.

ii. Absorbtion by parent commercial banks

iii. Strategic alliances

Bank Negara Malaysia has set March 31, 1998, as the deadline for the finance companies to identify their merger partner and agree in principle to the terms and condition of the mergers. Under the consolidation process, BNM has identified four tier-one finance companies to merge with the small and medium-size finance companies. Subsequently, all finance companies have responded the Bank Negara Malaysia's call to merge and initially six anchor finance companies that have agreed to merge with the smaller finance companies and their respective merger partners are shown in table two.

Table 2 : Anchor Finance Companies and its Merger Partners

Anchor Finance Company	Merger Partner
1. Mayban Finance Berhad	Amanah Finance Malaysia Berhad
2. Public Finance Berhad	Kewangan Industri Berhad, Boon Siew Finance Berhad
3. Hong Leong Finance Berhad	Bolton Finance Berhad, Kewangan Bersatu Berhad
4. Arab-Malaysian Finance Berhad.	Abrar Finance Berhad, Sime Finance Berhad, Advance Finance Berhad.
5. EON Finance Berhad and Credit Corporation (M) Berhad.	City Finance Berhad, Cempaka Finance Berhad, Perkasa Finance Berhad
6. United Merchant Finance Berhad	BBMB Kewangan Berhad, Perdana Finance Berhad, Interfinance Berhad, Delta Finance Berhad.

Source : BNM

To ensure that the financial position of acquiring anchor institution is not weakened , and to ensure that the regulators contributes its part in this effort to consolidate the industry through the merger process, the regulator will extend a one year guarantee to the acquiring anchor institution in the event of any further reduction in value of the acquired assets[5] which will be determined after a due diligence review.

In addition to the above, two banking groups will also be acquiring interest in two other finance companies. Affin Holdings Berhad will acquire a majority stake in ACF Holdings Berhad which has a wholly-owned finance company, Asia Commercial Finance (M) Berhad (ACF). Affin Holdings plans to merge the operations of its wholly-owned finance company, Affin Berhad with ACF. Furthermore, Bank of Commerce, which at present does not have a finance company is anticipated to enter into a strategic alliance with MBF Capital Berhad through a share swap involving an acquisition of at least 30% interest in MBF Finance Berhad in exchange for a 20% stake in Bank of Commerce (M) Berhad. These transaction will not be entitled to the one-year government guarantee.

Apart from the above, the consolidation will also be achieved through the absorption of assets and liabilities of the finance companies by commercial banks within the group. Business of the finance companies which will be absorbed by commercial banks within the group are listed in table 3.

In all the 14 cases mentioned in table three, the commercial banks will not be entitled to the one year government guarantee and they will not be allowed to conduct new hire-purchase business. The commercial banks are only allowed to manage and wind down the existing hire-purchase portfolio of the finance companies. Bank Negara Malaysia has said that it will continue to facilitate the merger process to ensure that the finance company industry will be successfully consolidated.

[5] Bank Negara Malaysia ,Press release of Finance companies Mergers,March31,1998

Table 3 : Absorption of Finance Companies by Parent Commercial Banks, Domestic Owned Institution

Domestic Owned Institution	Foreign Owned Institutions
1. 1.Phileo Allied Finance (M)	1. HSBC Finance (M) Berhad
2. Southern Finance Company Berhad	2. United Overseas Finance (M) Berhad
3. Hock Hua Finance Berhad	3. OCBC Finance (M) Berhad
4. RHB Finance Berhad	4. OUB Finance (M) Berhad
5. Sabah Finance Berhad	
6. Chew Geok Lin Finance Berhad	
7. Oriental Finance Berhad	
8. Multi-Purpose Finance Berhad	
9. Kewangan Utama Berhad	
10. BSN Finance Berhad	

Source : BNM press release of Finance Companies

After the Consolidation process, the number of finance companies will be reduced from the present 39 to 8 institutions, of which 4 are tier-one institutions. Seven finance companies have already complied with the new capital funds requirements of RM600 million ahead of the compliance deadline at the end of year 2000. However, the MBF Finance company has yet to achieve the RM600 capital funds requirements, it has already complied with the interim requirement of RM 300 million and has given an undertaking to comply with the RM600 million capital requirement by the stipulated compliance date. Although a majority of the finance company have met the minimum net shareholders' fund requirement under the ' Two Tier Regulatory System', tier -one status will only be accorded to finance companies that have met the requirements under the CAMEL framework.

1.5 Mergers of World Financial Institutions and Experiences

Consolidation in the number of banks in the United States during the 1980s and early 1990s was a trend and ongoing event. During this period, more mergers occurred in the banking industry than in any other industry. Much of the merger activity was driven by new kind of economic pressures and by the lifting of restrictive regulation that previously had isolated banks from competition. Continuing economic and deregulatory pressures probably will prompt many more mergers during the mid-1990s. Some observers believe that the number of financial institutions, were shrinked from more than 14000 in the late 1980s to 10,000 and possibly fewer by the mid 1990s[6].

In December 8, 1997, two of Switzerland's largest banks, the Union Bank of Switzerland and Swiss Bank Corp. were merged to form the world's second biggest bank with assets more than US $600 million. The merger is to form the United Bank of Switzerland through the form of share swaps with the target banks. As the increased capital will strengthen the bank's tendency to compete locally and internationally in the profitable investment banking market. The mergers has helped to rationalised the Switzerland's fragmented domestic retail banking system. The table four shows the international Banks merger and combined assets.

In addition, in Japan, the synergy was the rational factors that lead to the mergers between Japan's Bank of Tokyo and Mitsubishi Bank which created the world largest bank in April1997 with asset capitalisation of more than US $ 1 billion. The merger was a successful as it brought two banks which seemed compatible and relatively strong.

[6] Bank Management,G.H. Hampel, Page: 659

Table 4: International Bank mergers

Date mergers completed	Bank involved	Countries	Combined assets(US$billion)
December 1997	Union Bank of switzerland / swiss bank corporation	switzerland	600
April 1996	Bank of Tokyo/ Mitsubishi bank	Japan	783
September 1996	Chase Manhattan corp/chemical Banking group	United State	297
March 1992	Bank America corporation/ Security pacific corporation	Hong Kong / UK	193
March 1992 (announced)	Hong and Shanghai bank/ Midland Bank PIC.	Hong Kong and UK	NA
May 1991 (announced)	Banco Central / Banco Hispano Americano	Spain	85

Source: The Star January24, 1998

They had emerged without too much damage from the excesses of the booming economy and together they created a group with reasonable size and fit. In fact, the largest banking institution in the United States was established when Chase Manhattan Corp. and Chemical Banking Corp announced merger plans in August 1995. The third and final stage of the merger of the banks was completed in September 1996; just over a year after the plan was announced.

The mergers has caused downsizing the bank's operations and thus resulted in 12,000 jobs losses as 100 of its 480 branches were closed. The mergers between the two giants created synergy and diversification in the branch banking and portfolio of its products.

Therefore, the trend towards world mergers and acquisition is driven by several factors. One is the basic need to cut cost. When the economy of a country is booming, most of the banks ignored their cost control strategy as profitability was high. In a downturn , the pressure to control costs. The alternative way is to merge banks in order to reduce overheads, that is, reducing branch members and eliminating duplication. Secondly, the concern with the size factors. Many banks assumed that the largest will be capable being of competitive and leader in the market place. Finally, the desire to expand business into new ventures and areas. This includes cross-border expansion both with individual countries.