CHAPTER FIVE

THE EFFECTS AND CAUSES OF FINANCE COMPANY MERGERS

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5.1 The Effects Of Finance Company Mergers

Restructuring and recapitalisation of weak financial institution arising from mergers or consolidation, seemed to revitalise the finance companies industry. Finance companies are usually the first among financial institutions to suffer during tough economic times as being experienced now. And with hire-purchase business being badly affected by the current economic slowdown, and the consequent more by the authorities to curb credit growth, bank owned finance companies are somewhat willing to let go of their finance company licence. As such foreign owned finance companies were resorting plan to absorb their finance arms. For many others, specially smaller finance companies severely affected by the economic slowdown, they would be the target to takeover and mergers. However, the central bank has been urging finance companies to merge since the late 1980s. But with a decade long boom generating more than 8 % economic growth each year, there was plenty of business to go round and little incentive for finance companies to merge and share management control.

The aim of Bank Negara Malaysia is to prepare the finance company industry for the challenges of liberalisation. And the current difficult economic environment had instilled a sense of urgency that the finance companies must be restructured and recapitalised. There were a number of finance institutions were merged or absorbed in 1990s. The transformation of MUI bank into an emerging bank, Hong Leong bank, after its acquisition by the Hong Leong Group. Thereafter, the Hong Leong group bought over the ailing Visia finance (M) berhad and change its name to Hong Leong Finance(M) Berhad in December 1993. The MUI group recapitalised MUI finance (M) Berhad and change its name to United Merchant Finance (M) Berhad. Pertama Malaysia Finance Berhad was takenover by Perdana Finance(M) Berhad in January 1994.

The mergers and acquisition of finance companies were revitalised in the finance industry. Amidst these activities, other finance companies took effort to realign their management, modus operandi and refocus on business directions and market segmentation, in preparation for intense competitive environment ahead. The recent merger between RHB bank and Sime Bank has served as one of the successful mergers that recapitalise and absorbed their finance arms, namely RHB Finance Berhad and Sime Finance Berhad. Similarly, the mergers between Bank of Commerce and Bank Bumiputra Berhad , has created another successful story in mergers process of financial institutions. This mergers has absorbed the Bank Bumiputra's finance arm, BBMB Kewangan Berhad, and increased its capital base. This exercise apparently allow the new finance company to qualify for tier one status and comply according to the CAMEL requirement.

Moreover the benefit of merging are numerous but most of the benefit are relate to economy scale and saving in resources. In addition, the recapitalisation of finance company through injection of a larger capital would allow the finance companies to operate efficiently and share management control. Mergers also allow for pooling of resource, improve cost reduction and efficiency utilisation of scarce resources.

5.2 The Reason For Mergers and Acquisition In Malaysian Finance Companies.

5.2.1 The Finance Companies Crisis

The recent financial crisis has highlighted that the need for stronger capital bases, and most of local finance companies were small companies relative to their foreign owned finance companies competitors. Finance companies need to undergo mergers due to the need for consolidation in over-banked financial system. A schedule to raise minimum capital requirement in the finance company has triggered a frency of merger announcement.

5.2.2 Cost Reduction

One reason for mergers is that it will reduce costs. Two merging institutions can immediately reduce operating costs by consolidating administrative functions such as human resource, legal, planning, and product development. They can also cut cost by combining managerial functions such as directorship that do not need to be duplicated when the entity doubles its size. A large entity may also increases its financial services. Mergers, whether of banks or financial services within financial institution groups, resulting a more efficient management system. For instance, banks and finance companies have merged their automated teller services under the Malaysian Electronic Payment System (MEPS), and money changing and remittance -related services under the concept of *" Bureau de Change"*.

5.2.3 Market Power

One reason for mergers is that it will increase a combined finance companies market share. Increasing a firm's market share simply means that the finance company will be larger and will obtain economic of scale. Thus , increasing the size of finance company relative to other peers in an industry. Clearly , the security pacific- AMMB and MUI Bank-Hong Leong deals are example fitting this postulation. The most reason mergers between Bank of Commerce Berhad and Bank Bumiputra Berhad also create stronger market power to improve more favorable pricing such as deposit capture because of less perceived risk. This mergers also create corporate banking and retail banking expansion in the market which they are the leader. Large investment and fixed cost such as technology can be shared across a wider customer base , like in credit card processing. Skills also create more efficient operating process by improving predictability. A large branch average, has more regular work load than a smaller one and will lead to economic of scale.

5.2.4 Create Synergy

Achieving synergies is a much nobler reason to merge entities. Complementary product line, geographical coverage and skills are a power argument for mergers. Synergistic effects focus on the related to business operations, economic of scale, reducing marketing and distribution costs. Financial institution mergers in Malaysia probably are not voluntary mergers because the banking is a scare business right since the early 1960s. Finance company licence holder will not prepare to merge with another merely for synergy without financial compensation for giving his right to operate a finance company .

5.2.5 To Bail- Out Ailing Finance Company

It may be of interest to note that the Bank Negara Malaysia can be a direct party to a merger accusation scheme of finance companies in Malaysia. BNM is empowered under the law to purchase and share of a licensed institution which is allowed to grant loans to another licensed institution to purchase the share of an ailing licensed institution. Hence, the reason spate of mergers and acquisitions in the Malaysian finance companies and banking were largely prompted by the actions or the desire of the Bank Negara to restructure and recapitalise ailing finance institutions or to consolidate a smaller and weaker institutions into stronger finance institutions.

5.2.6 To Control and Maintain Sound Financial System of Finance Companies.

BNM measures are to protect the health of its financial institution system, to ensure that the industry continue to remain sound and resilient . The non performing loan(NPLs) jumped to 8.7% of total loans at the end of February 1998 from 6.8% at the end of December 1997[15]. Due to the downturn of economy, it is forecasted that non performing loans might peak at more than 20% of loans by end of 1998. Therefore, most of the finance company have been shaky due to liquidity constraint and incurred massive losses. With bad loans at average of 18.5% of total loans[16]. This phenomena has prompted Bank Negara Malaysia to restructure and recapitalise, especially the problematic small finance companies by requiring increased their capital base.

In order to strengthen the finance company's capital base, BNM has announced the minimum risk-weighted capital ratio requirement for finance companies would raised gradually from 8% to 10% with effect from January 1, 2000, with an interim ratio of 9% to be complied by end of 1998. The minimum capital funds for finance companies will also be progressively increased from the current RM5 million to RM 300 million by June 1999 and subsequently to RM 600 million by end 2000.

As such small finance companies which are incapable to raise the new capital requirement , have been requested to team or merge with stronger finance company (Tier-One finance company) . In addition, the entire finance sector need to consolidate to compete when Malaysia opens its financial business to greater foreign competitor in a few years.

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[15] Asian wall street journal, December 31,1997
[16] Asian Wall Street Journal December31, 1997

Table 5 : Non Performing Loans of Finance institutions

Non performing loans(NPLs)				
	June 1997 (6 Months*)	Sept 1997 (3 Months#)	Dec 1997 (3 Motnhs#)	Loan loss Provision % of NPL
Commercial Banks	3.5%	4.9%	5.3%	72.6%
Finance companies	4.3%	9.7%	9.9%	43.7%
Merchant Banks	2.0%	3.8%	5.1%	59.1%
Banking system	3.6%	6.1%	6.5%	60.6%

Source : The Star, February18, 1998.

* Based on classification policy of recognising NPLs, when loans are in default for 6 months.

#Based on new classification policy of NPLs in default for 3 months(reviewed in 1997) .

5.3 Difficulties Of Merging

The pace of financial sector consolidation and mergers that BNM has been pushing for appears to slackening. BNM announced the financial merger programme last year(1998) to encourage the consolidation of the country's 39 Finance companies into six core groups which will be stronger and better capitalised. Since the programme was launched, 14 bank-backed finance companies have been absorbed by their parent commercial banks. But, only two mergers have been taken place, that is, between RHB Finance Bhd and Sime Finance Bhd upon merging by their parent commercial banks.

However, there are a number of finance companies, particularly non bank backed finance companies are scrambling to merge with each other, despite the BNM identified six "anchor" companies. The recent development that the decision by two Sarawak- based finance companies to pull out mergers talks involving three other firms in the sector. The proposed alliance agreement between two peninsular -based finance companies had lapsed (refer table One).

Table 6 : Finance companies absorbed by commercial banks

No	Domestic Owned institutions	Commercial Banks
1	PhileoAllied Finance (M) Bhd	Phileoallied Bank (M) Bhd
2	Southern Finance (M) Bhd	Southern Bank(M) Bhd
3	Hock Hua Finance(M) bhd	Hock Hua(M) bank
4	RHB Finance(M) Bhd	RHB bank(M) Bhd
5	Sabah Finance(M) Bhd	Sabah Bank(M) Bhd
6	Chew geok Lin Finance(M) Bhd	Wah Tat Bank(M) Bhd
7	Oriental Finance(M) Bhd	Oriental Bank(M) Bhd
8	Multi purpose Finance Finance(M) Bhd	Multi Purpose Bank(M) Bhd
9	Kewangan utama(M) Bhd	Bank Utama(M) Berhad
10	BSN Finance(M) Bhd	BSN Commercial Bank(M) Bhd
	Foreign Owned institution	**Parent banks**
11	HSBC Finance(M) Bhd	Hong Kong & Shanghai Bank (M) Bhd
12	United Overseas Finance(M) Bhd	United Overseas Bank (M)Bhd
13	OCBC Finance (M) Bhd	OCBC bank (M) Bhd
14	OUB finance(M) Bhd	Overseas Union Bank (M) Bhd

Source : Bank Negara Malaysia

Delta Finance Berhad and Inter Finance Berhad, which were supposed to merge with United Merchant Finance Berhad as well as BBMB Kewangan Berhad and Perdana Finance Berhad have called off their merger plans. One the other hand, the proposed strategy alliance between MBF Finance Berhad and Bank of Commerce(M) Berhad- a unit of Commerce Asset Holding Berhad was off due to expiry of their Memorandum of Understanding(MoU) on December31,1998. The management of MBF Finance is now in the supervision of BNM after the company's shareholders fail to come up with a viable recapitalisation plans.

MBF finance is the highest non bank owned finance company with branch network of 153 and a customer base of 2.5 million, is estimated about RM 3.0billion was required to recapitalise the company which was saddled with massive non performing loans(NPLs).

There are numerous reasons highlighted for the failure of mergers or negotiation between the merger partners. Overexposed companies were reluctant to throw in their lot with their larger counter parts[17]. Instead, what is doubt is the willingness of larger companies to absorb the bad debts and non performing loans of smaller firms. This same reluctance was a stumbling block that ultimately halted a similar merger programme in Thailand.

The merger will be a positive move for the longer term but they may pose a short-term earnings drag on finance companies due to raising non performing loans and higher provision. The ratio of non performing loans to total lending to rise sharply 15% to 20% compared with the current level of about 8%[18]. Therefore, the financial strain absorbing bad debt could hinder the merger initiative.

A few shareholders of finance companies, a merger is not a very profitable prospect, not only because it would mean that they have forgo the owning of finance company, but they will loose out on the so called premium attached to the licenced. In a decade ago a finance company licenced was worth of several hundred million ringgit. If the financial institutions is listed on the KLSE, then the finance company licenced would be have listing premium which worth more than non listed finance company. This premium, now, has been tied in the assets of companies which made provision of bad loans.

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[17] Asian Wall street Journal December31, 1997.
[18] Asian Wall Street Journal December 31,1997.

The economic environment appears to be unfavorable towards encouraging mergers between finance companies. This is due to some finance companies generating profit and compliant with BNM minimum requirement inclined to sell even at a significant premium to market price as they can earn this premium in relatively short periods. Another factor contributed to the difficulty is the owner of finance company will not prepare to allow their equity interest diluted below controlling levels. This runs counter to an implicit motive of mergers or consolidation.