CHAPTER 7: CONCLUSION AND RECOMMENDATIONS

7.1.0 Summary and Conclusions

While the commercial merits of the mergers are open to debate, it's certainly true that the benefits have yet to be reflected in the bottom line. Fourth quarter results of the top 5 banks were muted, with loan growth averaging 4%, only slightly above the 2% industry average. Malaysia's slow economic growth means that banks are now grappling with slower loan growth and the possibility of deteriorating asset quality. This is likely to prolong the post-merger 'recovery' and further delay any eventual benefits from the consolidation.

Although NPL ratio of banks worsened after the merger it was still within the manageable level of below 10% in net 6 months classification. We believe the figure would have been worse had the merger exercise not been implemented. Banks had no alternative but to write off substantial bad loans of companies, which were victims of the 1997 recession and economic crisis. The merger exercise has not achieved the objectives that were anticipated. Lower NPLs were expected after disposal to Danaharta and recapitalisation exercises but NPLs are now on the rising trend. For small banks, the intensified merger process may lead to loss of premium despite being well managed. As for anchor banks, the extensive scope of the mergers is likely to cause merger strains and potential problems in terms of funding and share dilutions. Winners of the process are likely those sizeable banks that are least entangled in mergers. Even in those cases it is said that the actual benefits would only be realized in two to three years time, at the earliest.

Malaysia has had significant foreign presence in the banking system since the 1880s. While the domestic banking institutions have moved in a deliberate manner to build up their capabilities to expand and provide new services, foreign banks have for the most part been able to move much faster. The
more innovative foreign banks have in fact continued to grow their business despite the branching restriction. They are able to leverage on the research and development initiative, expertise and off-the-shelf products or inherit new delivery systems already tested by their parent banks. As such, the foreign banks have generally been better able to identify and react to changes in the market much faster than most domestic banking institutions. They are able to open new distribution channels that operate beyond the traditional delivery methods for financial services. Using new delivery systems and largely relying on new technologies, foreign banks have generated a more competitive environment for the domestic banks. Progress has been achieved as the gap between domestic banks and foreign banks in terms of return on assets has narrowed. On an annualized basis, the ROA of the domestic banks has improved to 1.2% for the first quarter in year 2002 compared with 1.5% for the foreign banks. The gap was 1.1 percentage points in June 2001. The ROA of the top quartile of the domestic banks is even higher at 3%.

Therefore, the survival of domestic institutions will be dependent on their ability to improve their efficiency and effectiveness in product offering so as to be at par with world-class players. As market forces assume a greater role, domestic banking institutions must be proactive in their strategies in order to compete with global players. Innovation and strategic reengineering will be vital, as the process will eventually see domestic banking institutions having to redefine their focus and finding their own niches with assistance from the regulatory authorities. The regulatory environment will influence the future landscape of the banking sector. Changes in regulatory philosophies and approaches to be undertaken aim to provide conducive environment for growth and expansion of banking institutions. The key to this is the ability of individual banking institutions to adapt swiftly as well as respond and adjust to the new rules.

Banks which do not make investments to take advantage of the new technology may find themselves losing customers to better quality or lower cost products of banks that do. Investing in IT however, entails high cost and
uncertain payoff. The changes brought about by IT - new products, more sophisticated customers, changing cost structures, and enhanced competitive pressures - have all combined to transform the structure of the banking industry. Advances in IT have also resulted in new database technology and data mining techniques that can expand the range of services that banks may offer their customers. The winners will be those who are able to harness on the capability of ICT (Information and Communications Technology) in making strategic decisions - in terms of enabling better alignment of businesses, enhancing organizational capacity and capability such as risk management, and building better customer relationships. Today, decisions on ICT investments demand a more thorough assessment, extending beyond the cost implications, to include better human resource redeployment, more efficient work flow process and system interface, expandability of the technology platform and the level of complexity to users and customers.

On the consumer front, a change in mindset will have to be evolved over time. A more competitive banking system should produce benefits to their customers and the business in terms of easy access, quality choices and competitive prices. Consumers must take charge of their own finances to engender a competitive environment and lower the cost of capital. In order to achieve this, a proactive education programme has to be implemented for the consumers to be able to make well-informed financial decisions. Transparency will need to be enhanced, both at the product and institutional levels to promote consumers’ awareness of banking and financial products. Similarly, greater flexibility in product pricing that would lead to competitive and differentiated strategies among banking institutions, will eventually benefit genuine customers, in the form of lower costs. An indicator of the improved level of competitiveness has been the narrowing of margins. During the year 2001, gross interest margins of banking institutions have narrowed to 3.86% for the commercial banks from 4.3%. This reflected the larger reduction in the average lending rate vis a vis the average cost of funds. The competitiveness of the domestic banks in terms of the gross interest margin has also improved. The gap between the domestic banks and foreign banks has
narrowed from 0.92 percentage points as at the beginning of year 2000 to 0.69 percentage points as at the end of 2001. The ability of consumers to influence the market to react positively is an important enabler for deregulation within the domestic financial sector.

On completion of the merger exercise in December 2000, 6 anchor banks have succeeded in achieving synergy in terms of revenue. The overall total revenue for the 6 banks under review increased by 11.70% in December 2001 from the corresponding period in the previous year. This marginal increase in revenue is not indicative of a successful merger. The synergistic effect of the merger has not been fully seen due to many external forces like government regulations and slow growth rate.

The success of the merger of the banking institutions can also be gauged from the perspective of the shareholders. There are several significant issues affecting shareholders in the current environment. The global trend is being driven partly by an increased focus by banks on the financial performance and on the creation of shareholder value. In essence, the potential for growth lies in the value of their investments. This would be the right thing to do in the interest of long-term survival. Despite the narrowing interest margins and high costs, the banking industry has been able to increase their returns with the average return to shareholders in 2001 being 14.1%. Banks like other companies in a free market economy, have a responsibility to generate returns for their shareholders. It is in the interests of the community as a whole that they do so, otherwise we could end up with a weak banking sector.

Shareholder value can be maximized subject to constraints. These may be imposed by laws and regulations, or by the expectations of society. This means that if banks wish to preserve their reputation and the confidence of their customers, on which ultimately the strength of their franchise depends they should act in a way that is seen to be fair and reasonable. To do otherwise, may in the long term be inconsistent with the objective of creating shareholder value.
Profit, EPS and CAR deteriorated in Dec 2001 from Dec 2000 by 3.56%, 20.34% and 0.20% respectively. This was the result of the current weak capital market, Asian currency crisis and the recession in US and Japan. Banking mergers in Malaysia are reacting to a financial crisis after it hit them whereas the general mergers in the west are undertaken in anticipation of globalisation, a proactive rather than reactive strategy. Nevertheless, it may not be a cause for alarm as there are indications that world trade is expected to recover to about 2.5% in 2002. Growth in the major industrial countries as a group is expected to stabilize at 1.1%, as a result of a stronger growth of 1.4% in the US economy. Malaysia is well positioned to benefit from the emerging recovery in the global economy. Real GDP growth in the Malaysian economy is projected to recover to 3.5% in 2002.

Some bankers and economists see a potent political angle to the merger plan, arguing that it could be used to weed out banking players that are closely identified with Datuk Anwar. It seems as if the 6 anchor groups in the Central Bank proposal have close ties to the government. But two fast-growing financial groups that have been seen as having close links with Datuk Anwar – Hong Leong Bank Bhd and Philleeo Allied Bank Bhd have been slotted to be merged into larger banking groups. We also observe that the merger plan has run up against sensitive issue of race relations in multiracial Malaysia. Eight of Malaysia’s 21 commercial banking groups were controlled by ethnic Chinese business concerns. However after consolidation only two Chinese controlled banks emerged – one group headed by Public Bank and another comprising the merger of Southern Bank Bhd, and Ban Hin Lee Bank Bhd. two medium-sized financial institutions.

Favoritism rather than meritocracy emerged in the merger of Bank Utama. Although UBG did not meet the merger deadline of December 2000 they were given extension of time to find their merger partner. Bank Utama after may failed attempts only succeeded in merging with RHB in March 2002. Although Bank Utama did not satisfy the paid-up capital requirement, the rules were
bent to allow them time to raise the capital and qualify as anchor bank. This privilege was granted to UBG due to its political connections but was not given to other banks.

The timely implementation of the Financial Sector Masterplan (FSMP) helps to insulate local banks from the adverse effects of financial crisis and recession. We are of the opinion that authorities had taken the right step by implementing the FSMP, part of which was consolidation of banks. Though post merger results were not impressive, but the larger size of the banking groups will enable them to withstand international competition.

The creation of Danaharta, Danamodal and Corporate Debt Restructuring Committee (CDRC) had rescued some weak and vulnerable banking groups from going under. Danaharta had acquired assets pledged as securities for non-performing loans from financial institutions. Whereas Danamodal had injected billions of ringgit for undercapitalized banking institutions to increase their resilience and enhance their ability to generate new lending activities. CDRC had played an important part in restructuring the debt of viable corporations in order to minimize losses to creditors and shareholders and to avoid forcing viable companies into liquidation thereby preserving jobs and ensuring continued productivity in the economy. This had helped to maintain stability and avoid social unrest.

From the human resources and social perspective, the merger exercise had led to great uncertainty in the industry. As a measure to make their organization lean and efficient, a number of banks had offered VSS scheme to their employees, thus creating uneasiness and job insecurity among bank staff. In many cases the low morale of employees had adversely affected their performance. To the general public the merger exercise did not affect them significantly. However some bank customers were affected when their regular account officers or account managers with whom they had a long term
relationship, were not available to serve them or their regular branch had closed down and they were forced to bank elsewhere.

With the completion of the legal and operational aspects of merger, banks can settle down and assess processes and review the possibility of rationalizing the various procedures on group-wide basis. This will allow the new group to achieve greater operational efficiency and cost effectiveness and improve productivity in future. Banking institutions can expect to leverage on the opportunities presented by consolidation to exploit economies of scale, diversify and strengthen their earnings base and create bigger market presence. To forge ahead in the new economy, performance and resilience, however will not be enough. Size alone is not a sufficient condition that will result in producing efficient and competitive banks and it does not guarantee success. Being a large bank is however an important enabler to achieving enough scale to be able to invest in cutting edge technology and management systems and to attracting the talent required to compete with the best players in the market. Domestic institutions need to be able to match the range of products offered by foreign competitors. But the larger scale and wider range of activities will demand stronger management teams. A strong management team that is committed to bringing about improvement in overall performance, capacity enhancements, agility on a continuous basis and courage to implement strategic changes will be a necessity. With the completion of the merger programme in December 2000, the banking groups are at various stages in building up of their management team and enhancing corporate governance. A number of measures have been implemented to ensure that banking institutions' Board and key committees have sufficient representation of independent directors and that the Boards are encouraged to appoint qualified professionals to run the banks. Towards this end, BNM has liberalized the remuneration package of the chief executive officers of banking institutions and left it to the Boards to formulate appropriate packages to attract the necessary talent and determine their remuneration package.
7.1.1 Recommendations

With the completion of 10 anchor banks in the country, it would be important now to build a surveillance system to monitor the real performance and development that will be taking place after merger. Studies should be undertaken by various bodies to evaluate the extent of success and the implication and consequences of the consolidation process. We hope our research was timely and has contributed for this purpose. We believe that the industry must be forward-looking, proactive and pre-emptive in facing future challenges. The consolidation process should be ongoing until more resilient banks which can withstand all exigencies emerge. We strongly recommend that future consolidation should be market-driven rather than forced by the authorities. Merger partners should be decided by market force rather than favoritism.

As banking institutions continue to adopt greater sophistication in the application of ICT, efforts must also be intensified to develop ICT-savvy employees and to increase customers' understanding and acceptance of the new approaches. While the efficiency of electronic means of doing banking, such as electronic kiosks and Internet banking is valued, the need for personal attention cannot be ignored. While being engrossed in the technology race this factor should not be neglected. Banking business after all is about cultivating relationships, which will become more challenging as customers become better informed and knowledgeable as they move up the income curve.

Superior insights on customer needs will be an important advantage. This will involve recognizing the diverse needs of the different customer segments. There is now already a discernable change in the pattern of customer behaviour. There is an increasing shift towards a customer base that has less need for the standard distribution systems for most banking services. The preference is for services as much as possible over the telephone, ATM or Internet. Writing cheques has become an inconvenience. This new generation
of customers has their own ideas of what a bank should be and successful banks need to respond to this change.

Judging from the experience of other countries, we recommend that the fat be further trimmed to make the banking sector leaner and more resilient. This means another round of consolidation, further reducing the number of banks to three anchor banks with emphasis on best banking practices.

To remain competitive the merged anchor banks should adopt futuristic business models. For e.g. one party could concentrate on "selling" the loans while another party may "service" the loan whereas another specializes in product development. Each function performed by different specialist providers dedicated to their own specific functions and expertise in the chain. This new approach based on Capability Based Restructuring transforms business to become more flexible by concentrating on their capabilities. Maybank and Fortis have formed a joint venture to develop a bankassurance offering, an insurance product. Rather than develop their offerings organically from within, Maybank chose to partner with an established player in a synergistic relationship that exploits Fortis' capability and Maybank's distribution channel and customer base. Similarly, BCB made a strategic move by establishing a separate "for-profit" company, EPIC-I, to provide IT and back office processing services to the bank and its group of companies. The new company will eventually be positioned to undertake third party processing on behalf of other Malaysian financial and non-financial institutions.

In this period of rapid change, where change is the only constant, the successful organizations will be those that are able to recognize and identify the forces of change and how it affects them and make the required internal adjustments in response. Change mandates a need to create a new organizational mindset, capable of identifying opportunities and responding to them. Such organizations will be those comprising individuals with a clear sense of mission and empowerment and in which every level of the institution
is motivated and focused on achieving a consistent set of corporate objectives. In a service organization, it will always be the type of talent that is hired and retained that will make the difference. This is perhaps the greatest challenge facing banks. The level of knowledge and expertise are insufficient compared to the global providers.

Our findings reveal that the banking consolidation exercise did not fully accomplish the desired goals they set out to achieve but we are assured that the implementation of the exercise by BNM is timely and domestic banks are now better positioned to respond to the new and changing economic environment.

In conclusion, the recent bank mega mergers worldwide signify structural changes in the banking industry, unfettered by archaic geographic restrictions on competition. There are ample opportunities afforded by new and emerging technologies. These changes are squarely in the public interest. However, it is the central banks' and other watchdogs' responsibility to ensure that these changes are consistent with relevant banking laws and serve the public interest.

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