CHAPTER 4: RATIONALE AND CONCERNS OF MERGER

4.1.0 Rationale for merger

Given the more competitive financial landscape arising from greater globalisation and liberalization, it is important for banks to respond promptly to enhance capacity and capabilities. All countries are now moving towards consolidating their banking system and Malaysia cannot be the exception. The process of getting the banks to merge in Malaysia started in earnest in mid 1980s as a result of economic recession. The policy however has always been to allow market forces to dictate merger pace. The result has been dismal as seen in the slow reduction in the number of banking institutions. Please see Table 2. In the mean time, the banking crisis in the mid 1980s propelled a number of weak commercial banks and finance companies into insolvency and financial distress. These institutions were badly hit as they were saddled with huge NPLs, the aftermath of over lending to the property sector, imprudent exposure to share based lending during the earlier boom years, mismanagement and high exposure to foreign loans.

Table 2: Reduction in no. of financial institutions for the period 1980 to 2000

<table>
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</thead>
<tbody>
<tr>
<td>Commercial banks:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Domestic</td>
<td>17</td>
<td>16</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>• Foreign</td>
<td>4</td>
<td>6</td>
<td>9</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Finance Companies</td>
<td>47</td>
<td>45</td>
<td>39</td>
<td>25</td>
<td>19</td>
</tr>
<tr>
<td>Merchant banks</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>97</td>
<td>95</td>
<td>86</td>
<td>71</td>
<td>55</td>
</tr>
</tbody>
</table>

Source The Star 11/8/99
4.1.1 Globalization

Bank Negara Malaysia (BNM) had announced a consolidation programme for the domestic banking sector on 29 July 1999. The merger programme was aimed at consolidating the domestic banking industry into 10 banking groups to achieve a more effective and competitive banking system. BNM had granted the domestic banks flexibility to form their own banking groups (BNM statement 10/8/99).

The United Kingdom has four major banking groups, Australia has four major banking groups and Singapore two. The experience of these countries has proved that consolidation in the financial sector is both viable and desirable. The IMF too has forced countries under their programmes (Indonesia, Thailand, South Korea and Japan) to reduce the number of banking institutions by effectively closing them down. Malaysia does not believe that the IMF prescription of closing down the problem banks is the way to go as the social costs involved in terms of dislocation of resources are high. Without merger, the small non-bumiputra financial institutions are likely to disappear as a result of increased competition. Small banking institutions cannot survive once the financial market is opened up. Table 3 showing in the following page is the ranking of Malaysian Banks in Asia.
Table 3: Ranking of Malaysian Banks in Asia

<table>
<thead>
<tr>
<th>NO</th>
<th>LOCAL BANKS</th>
<th>TOTAL ASSETS 2001 (MIL)</th>
<th>RANKING IN MSIA</th>
<th>RANKING IN ASIA 2001</th>
<th>RANKING IN ASIA 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Maybank</td>
<td>127,323</td>
<td>1</td>
<td>66</td>
<td>73</td>
</tr>
<tr>
<td>2.</td>
<td>Bumiputra Commerce</td>
<td>63,179</td>
<td>2</td>
<td>122</td>
<td>123</td>
</tr>
<tr>
<td>3.</td>
<td>RHB Bank Bhd</td>
<td>50,612</td>
<td>3</td>
<td>143</td>
<td>142</td>
</tr>
<tr>
<td>4.</td>
<td>Public Bank Bhd</td>
<td>44,236</td>
<td>4</td>
<td>151</td>
<td>160</td>
</tr>
<tr>
<td>5.</td>
<td>Hong Leong Bank</td>
<td>29,290</td>
<td>5</td>
<td>196</td>
<td>219</td>
</tr>
<tr>
<td>6.</td>
<td>Southern Bank Bhd</td>
<td>23,446</td>
<td>6</td>
<td>222</td>
<td>265</td>
</tr>
<tr>
<td>7.</td>
<td>Eon Bank Bhd</td>
<td>17,218</td>
<td>7</td>
<td>270</td>
<td>292</td>
</tr>
<tr>
<td>8.</td>
<td>Affin Bank Bhd</td>
<td>15,645</td>
<td>8</td>
<td>278</td>
<td>283</td>
</tr>
<tr>
<td>9.</td>
<td>Arab-Malaysian Bank</td>
<td>11,731</td>
<td>9</td>
<td>309</td>
<td>309</td>
</tr>
<tr>
<td>10.</td>
<td>Allied Bank Bhd</td>
<td>9,329</td>
<td>10</td>
<td>340</td>
<td>337</td>
</tr>
<tr>
<td>11.</td>
<td>Bank Utama Bhd</td>
<td>6,308</td>
<td>11</td>
<td>368</td>
<td>366</td>
</tr>
<tr>
<td></td>
<td>TOTAL</td>
<td><strong>398,316</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

FIRST 6 LARGEST BANKS - Total Assets RM338,086mil(85%)
Source: Asiaweek dated 14/9/2001

Maybank, which acquired two domestic commercial banks, is still 40% smaller than the largest bank in Singapore (DBS Group) in terms of total assets. The other banking groups in Malaysia are smaller than the 2nd largest bank in Singapore.

Given the more competitive financial landscape arising from greater globalization and liberalization, it is vital for banking institutions to respond promptly to enhance capacity and capabilities. Market forces would induce further rationalization and consolidation. The ultimate objective is for the creation of a domestic banking sector that is efficient, effective and competitive in a stable environment that can support and facilitate sustained and balanced growth of the Malaysian economy.

4.1.2 Duplication of Resources

With 71 banking institutions, Malaysia was over-banked and some resources were wasted due to duplication. The only viable solution is for a merger, which removes smaller financial institutions. There are currently 11 locally owned
commercial banks (excluding the 14 foreign-owned banks), 11 finance companies and 9 merchant banks as at June 2001. Nevertheless, this number is still too big for a small market like Malaysia’s, which has a population of only 23 million and a gross national product (GNP) of RM311 billion.

It was clear that some resources were wasted due to duplication of branches in the same locality. The creation of six domestic financial groups ultimately will ensure that the domestic banking institutions will be able to withstand pressures and challenges arising from an increasingly competitive global environment.

4.1.3 Economies of Scale

A well-planned merger exercise would generate significant benefits for both the economy and the banking industry. The creation of bigger, stronger and well-capitalized banking institutions would mean stronger financing muscle and economies of scale. The exercise would also remove the weaker banks as weak links in the banking system. The smaller number of banks also means easier control for the authorities.

4.1.4 Deregulation

In the Financial Sector Master plan, Bank Negara indicated that incumbent fully foreign-owned banks in Malaysia would gradually be able to operate on a more level playing field with domestic banking institutions with increasing deregulation. This will begin with the removal of some of the existing restrictions on incumbent foreign players, such as those on off-branch automated teller machines (ATMs) and a shared ATM network. This deregulation could happen as early as 2004 and will add competition to domestic banking institutions.
4.1.5 Overseas Acquisition

The Financial Sector Masterplan also indicates that Malaysia would consider introducing new foreign competition. Bank Negara has said this could happen as early as 2008. Apart from consolidation, this liberalization is also intended to prod domestic banks into rationalization (overseas acquisitions).

The new Basle Capital accord which, among other things, will change the way a bank’s capital ratio is calculated, could have a negative impact on bank profitability and force another round of consolidation. The new accord is due for full implementation on Jan 1, 2004. Apart from the ‘push’ factors, there are also incentives for Malaysian banks to pursue a second round of mergers.

4.1.6 Future Cost Savings

As can be seen from a couple of the recent mergers, consolidation has its benefits in the form of future cost savings. The two largest banking groups in Malaysia are taking the lead, with Maybank and Bumiputra-Commerce Bank having completed their VSS (voluntary separation scheme) to reduce staff headcount and costs. In each case, anticipated staff cost savings is estimated at between RM30 million and RM90 million a year (per bank).

4.1.7 Increased Bank Network for Small Banking Groups

Bank Negara had shown its flexibility in allowing branches of finance companies that were acquired or absorbed by commercial banks to be converted into commercial bank branches. Recently BNM approved the conversion of 10 Affin-ACF Finance branches (out of 75) into Affin Bank branches. This flexibility could be very attractive to those banking groups that have a relatively small commercial banking presence or branch network.
4.1.8 NPLs threaten stability of banking system

One important fact to note is that despite the progress achieved thus far in bank restructuring, the non-performing loans (NPL) still remain large. Owing to the slowdown in the manufacturing and export sectors, the weak stock market and the expiry of the exemption period extended to certain large delinquent accounts by BNM, NPLs are expected to continue to rise in the current and next quarters. For instance, on the gross basis, the NPL of the banking system amounts to RM72bil on 3-month basis and RM53bil on 6-month basis. The portion for finance companies is RM20bil and RM14bil respectively. Without comprehensive merger, it is possible these NPL could threaten the stability of the banking system in the future, with the smaller financial institutions dragging down the bigger ones.

4.1.9 Remove inefficiency

The smaller institutions, due to their inefficiency, tend to offer higher interest rates and compete aggressively for deposits. They tend to price their loans higher to pay for higher deposit rates and get high-risk borrowers because good borrowers go to bigger and stronger institutions with lower lending rates. In the end, whenever economic problems set in, the small institutions get hit first. This was what happened to (Deposit Taking Cooperatives) DTCs and finance companies in the past, and is threatening to bring down smaller banks now.

These institutions were badly hit by the 1985-1986 recession as they were saddled with huge levels of NPLs, the aftermath of over-lending to the property sector and imprudent exposure to share-based lending during the earlier boom years. Given the severity of the losses and to maintain integrity of public savings and the stability of the financial system, BNM had to implement a rescue scheme.
The rescue scheme involved BNM acquiring shares in some of the ailing commercial banks and the absorption of the assets and liabilities of the insolvent finance companies by stronger finance companies. As a result of the rescue scheme, the number of finance companies was reduced from 47 to 40. The merger of one commercial bank and the consolidation of the finance company industry were thus driven by the rescue scheme in order to restore stability in the banking sector. The design and the implementation of the rescue scheme had been a very costly experience to the nation as a whole.

4.1.10 Competitive Advantage through advanced technology

Technology allows firms to compete across geographical boundaries and customer segments while trying to price their products competitively with an adequate return to shareholders. Being efficient and focused in the technology world is a key determinant of competitiveness. Technology is also becoming a driving factor in determining who will merge with whom. Judging by the growing expenditure on technology, it appears that only financial giants will have enough money to invest in the future electronic banking.

Malaysian banks' expenditure on technology is considered small compared to that in the US or Europe. The industry's consolidation exercise has to be expeditiously completed, as it will provide an added boost to the development of e-banking and internet-based services. The US currently has 232 cyber banks while Europe has more than 500. The number is growing in both markets. The benefits of the technology revolution accrue most in large-scale banks. Back-office operations like data processing and billing get cheaper as the customer base gets bigger. The ability to share customer and product information via computer networks has greatly lowered the cost of maintaining far-flung branches. Hence, technology allows firms to compete across geographical boundaries and customer segments while trying to price their products competitively with adequate return to shareholders.
4.1.11 Social Benefits

There are social benefits that come with the emergence of big banks. Banking mergers are leading to the creation of so-called financial supermarkets that will be able to handle everything from customers' checking accounts to credit cards, mortgage, insurance and even stock portfolios. One popular hypothesis is that individual banks merge to increase their market power, and it is evident that national market shares have been steadily increasing in banking. However, banking is still relatively fragmented nationally and is less concentrated compared to other major industries.

Before the merger wave, banks were relatively protected from competition. But today's competition is forcing banks to differentiate themselves at the service level. Large banks exploit the economies of scale in the production of standardized "low-touch" banking products. High-touch community banks focus on high-quality tailored services. These additional choices in the new environment will certainly improve customers' well-being. They will have more options to choose from.

4.2.0 Concerns on Mergers

4.2.1 Higher Costs

While technological progress and heightened competition are typically thought to be good for customers, many have greeted the banking merger trend with anxiety. Recent attention has focused on three such fears. Firstly, as banks merge, banking fees tend to become fatter. It also appears that banks have become more aggressive in their assessment of service charges and fees over the last decade.
4.2.2 Quality of service deteriorates

Secondly, when a bank is taken over, its customers often complain about the quality of service of the new entity. This may be true at least for two reasons. First, the mix and pricing of products are likely to change or be standardized with the merger, so much so that customers preferring the old product mix will be less satisfied. Such standardization occurs to capture the benefits of the economies of scale. Without standardization, information sharing that drives mergers would be inefficient at best. Cost savings would also be lost with each merger, if the acquirer adds a new set of products or different versions of the same products. This standardization can be a significant disadvantage to customers who are accustomed to tailored services and want them to continue. Second, as firms grow in size a natural numbing effect on service quality and initiative will occur. For example, a big retailer cannot offer an individualized service of a small retailer. This is because employees who are responsible for a much broader line of products may not have the intimate knowledge of each product often found in smaller more specialized shops. The same hold true for the banking industry. Thirdly, the availability of credit may be adversely affected particularly to small businesses. Smaller banks are a primary source of small-business credit. As larger banks take over small banks, small business enterprises will find it difficult to obtain loans.

4.2.3 Standard Products

Again technology and competition are forcing banks to specialize in the way they serve customers, including small businesses. They may offer small businesses a menu of standardized, quick-turnaround loan products. Because of the cost advantage in offering homogenous products, large banks are likely to dominate such lending while providing speed and convenience with the technology in hand.
They may also offer low interest rates as competition intensifies. Finally, easy comparison can be made as standardized loan products vary little and are offered by many banks.

On balance, there is an excellent chance that small businesses will find a wider array of loan products to choose from. The mergers currently taking place may create transitional costs as long standing banking relationships are lost or altered in the re-organization. Ultimately, small businesses should benefit from a broader selection of lending institutions to meet their specific needs.

4.2.4 Valuation

Bank Negara gave a set of guidelines on the merger exercise when it was first announced. For a non-listed bank, the share price will be based on a multiple of the bank's net tangible assets, with its earnings capacity taken into consideration. For a listed company or subsidiary of a listed company, the prices will be based on the weighted average market capitalization of the listed company over a certain period (times a proportion of the subsidiary's profit contribution for the second). Even with the guidelines, the valuation will be a thorny issue for the shareholders and banks involved. This means where a bank has two banking licenses before one will have to be cancelled, unless the banks can maintain their separate logos, which is unlikely. A banking license has a premium – it used to fetch as much as RM500 million some time ago, when the economy was more buoyant. This should be taken into consideration in the pricing. This can be difficult.

The important thing is that the shareholders of the smaller banks should not be shortchanged. So some of the banks will have to offer higher prices for the banks being acquired, especially now when the economy is more buoyant and values have gone up. Bank Negara also wants a cash option available to those who want to take it, so this too can be tricky.
4.2.5 Increasing Restructuring Costs

Another constraint is that the banks' individual strategies, IT systems and even customer and deposit bases may be totally different. These are problems, which have to be ironed out, and if merging entities are big in their own right, it will take time. Some banks may take as long as three years to complete their restructuring. It puts a lot of pressure on people in the industry and everything in a standstill in the meantime- portfolios, timetables, plans. Hence psychological constraints are imposed on people and it will be onerous – there will be a lot of restructuring and wastages. For example, when there two branches of a bank in about the same location there is bound to be wastage.

4.2.6 Staff Redundancy

The analysts do not expect any recruitment in the banking sector over the next few years. Instead, they foresee redundancies and quite a bit of natural attrition among banking staff.

In the midst of this massive shake-up, the beneficiaries initially will be the foreign banks and those who have completed or are close to completing their mergers. The local banks will be devoting their attention to their internal restructuring over the next couple of years, giving foreign banks a chance to increase their markets share since they are not bothered with all this. So it is a short-term setback for the local banks, but it is a necessity.

Another issue that analysts foresee is problems of 'cultural fit' among some of the banks to be merged.
4.3.0 Liberalization of the Economy

4.3.1 The Financial Sector Masterplan

A blueprint to chart the way forward for the country's banking, insurance and other financial sector players for the coming decade has been unveiled, with liberalization of the economy. Named the Financial Sector Masterplan, it came on the heels of another blueprint, the Capital Market Masterplan.

The objective of the Financial Sector Masterplan (FSMP) is 'to provide the blueprint for the development of an effective, competitive, resilient and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy through the economic cycle, and has a core of strong and forward looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalization and globalization'. A well-diversified and competitive financial system is vital for the long-term economic growth development to ensure that risks in the economy are well distributed among the various sub-sectors. The plan recommends a seven-year timeframe to introduce new foreign competition for the banking sector and a 10-year gap for the insurance sector. The grace period is to give existing local entities time to beef up their position to face the impending competition.

The banking and insurance industry are prominently featured in the FSMP. Banking and insurance, including Islamic banking and takaful, took the lion's share of the regulators attention with 81 of the 115 recommendations embedded in the masterplan. The other recommendations deal with the Islamic banking and takaful, development financial institutions (DFI), alternative modes of financing and Labuan international offshore financial center.
Finance Minister Tun Daim Zainuddin launched the 263-page document, prepared by BNM on March 1, 2001, exactly a week after the Securities Commission’s capital market blueprint launch. The regulator’s intention is to open up the financial sector in a three-tier phase, basically revolving around the themes of enhanced domestic capability, consolidation and liberalization.

For the banking sector, the first phase from 2001 to 2004 will see the strengthening of domestic institutions’ capacity and capability to compete. Phase two, beginning 2004, will see the intensifying of pressure on domestic players by loosening the current grip on their foreign counterparts. This includes allowing incumbent foreign banks to set up shared Automated Teller Machines (ATM) and open more branches. Phase three, from 2007 to 2010, is envisaged to assimilate local players into the global arena with the introduction of new foreign competitors. At the end of the masterplan timeframe, the first of its kind for Malaysia, it is hoped the country would have in place a financial sector substantially different in order to remain competitive.

For the financial institution landscape, the plan envisage the presence of a few large financial institutions providing a broad range of products and operating side-by-side with specialist financial institutions.

In the banking arena, analysts believe foreign banks with almost a quarter of the market share may see some increase should local banks fail to take advantage to beef up their services in the next few years.

4.3.2 The Financial Sector Landscape in 2010

While it may not be possible to project accurately how Malaysia’s financial sector will be structured in 10 years time, taking into account the forces at work and how the challenges facing the industry are met, the future financial landscape can be expected to be characterized by the following:
An increasingly more diversified financial sectors meeting the requirements of a more diversified economic structure:

The competitive environment in the banking sector is likely to result in institutions with differentiated strategies based on their strengths and market niches. This implies that: Fewer large, broad based institutions will thrive, exploiting their privileged relationships with retail customers and mid-market corporates to provide a full range of financial services to market segments that value banking relationships and/or convenience.

The successful institutions will be those who continue to leverage on the advancements made in technology, in reengineering work processes and delivery modes, and offering state-of-the-art products and services that serve as complete financial solution for varying types of consumers.

Employing and retaining highly skilled workers and the re-skilling of existing work forces and promoting a culture of continuously learning and unlearning will be continuously pursued, as human factor becomes a defining characteristic of a successful banking institution. Specialist providers will emerge. Some competing to provide specialized products such as mortgages and credit cards on the basis of lower costs or better marketing. These players are likely to be regional or global in scale. Some competing only in particular segments of the business system, while outsourcing all other functions (such as mortgage originators, credit card processors or custodial service providers) and some dominating certain customer niches, such as the SMS (small and medium scale) or high net worth individuals, by providing specifically tailored services beyond traditional banking offerings to satisfy the needs of customers whom they understand better than a more generalist competitor.
4.3.3 Approach to Implementation

The change programme involving 119 recommendations to be implemented over the next 10 years will undergo three phases of implementation, subject to achieving certain milestones and safeguards. The first phase is focused on building the domestic capacity, the second phase is about increasing domestic competition and the third phase sets the pace for the integration with the international market.

During the early years of implementation of the FSMP, the emphasis will be on capacity building. This will include the implementation of measures to enhance the capability of financial institutions to compete and become more efficient and effective, as well as measures to promote stability. The regulatory and institutional infrastructure would be further enhanced, while a more efficient consumer protection framework would be instituted.

The next phase of development would involve the gradual deregulation of the domestic financial market, intended to bring about greater competition between the various financial institutions. At this stage, incumbent foreign financial institutions, specifically in the banking sector would be able to compete on a more level playing field with the domestic institutions. Financial institutions during this phase would be expected to demonstrate a high level of professionalism and expertise, which would be the result of a long process of domestic capacity building initiated earlier. A diverse range of financial institutions each having their own expertise and capability will compete and at the same time complement each other to meet the increasingly differentiated demands of the consumers. By then, a strong corporate governance should be well-entrenched among these institutions prompted by the regulatory pressure as well as greater activism from their shareholders and other market participants. Greater exposure and experience in the various financial markets, and the use of hedging instruments over time, would raise the standard of risk management practice among financial institutions. The efficient functioning of various customer protection mechanisms and the
framework for achieving socio-economic objectives laid down during the initial stage of FSMP implementation would be necessary before competition is further intensified during this phase.