Chapter 1

Introduction

1.1 Problem Statement

Whether or not bank mergers actually achieve the expected performance gains is a critical question. Hence, the objective of this research is to evaluate the effectiveness of the recent consolidation of domestic banking institutions (BIs) by Bank Negara Malaysia (BNM). We evaluate the effectiveness of bank mergers by comparing the performance of the banking system before and after the mergers.

Our study follows that of Rhoades (1986, 1990), Srinivasin (1992) and Pilloff (1996), which assess the pre merger and post merger operating performances utilising pre and post merger traditional accounting data to generate financial ratios, such as the most commonly used measure for bank performance - Return On Assets (ROA), Return On Equity (ROE) and Cost Efficiency Ratio (CER). Post merger data are compared with pre merger data to determine the performance changes that took place upon the transition period from pre merger to post merger.

1.2 The Banking Industry in Malaysia

The banking sector plays an important role as a financial intermediary and is a primary source of financing by mobilising and channeling the scarce resources of the economy. These resources would then be used to their optimum level in order to achieve maximum economic development of the nation. Malaysia's banking sector had recorded a rapid and extensive growth by building up branch network throughout the country aggressively, is able to deliver specialised value added banking services and products as well as highly sophisticated range of facilities and increasingly flexible credit activities.

Malaysia's BIs comprises licensed institutions namely commercial banks, domestic and foreign, finance companies, merchant banks, discount houses, money brokers and Islamic banks, which are licensed under the Banking and Financial Institutions Act 1989 (BAFIA) and supervised by BNM, the Central Bank of Malaysia. Commercial banks are the largest financial entities and provide the greatest number of services to both corporate and retail customers (BNM, 2001).

The measures initiated by the World Trade Organisation (WTO) and General Agreement on Trade in Services (GATS) have great social and economic implications on Malaysia's landscape of its domestic banking sector. This move was seen as the start of BNM in embarking on a widespread awareness programme of strengthening the banking sector for long term survival and growth of the Malaysian banking sector via nationwide merger exercise. Thrust of the merger and consolidation programme is a necessary pre condition to create a core group of strong, efficient, well capitalised and competitive domestic BIs in order to achieve a more effective banking system. The whole merger programme is to consolidate the perceived smaller financial institutions with the bigger ones, where the anchor banks are first chosen.

As a member of the World Trade Organisation (WTO), Malaysia is under increasing pressure to open up her financial markets for greater foreign participation. Therefore, the need to push and accelerate the consolidation and merger process is now very obvious in order to survive the entry of larger and more competitive foreign banks.

However, the domestic banking merger pace is still considered slow, according to Governor of BNM, 10 August 1999, Tan Sri Dato' Seri Ali Abul Hassan Bin Sulaiman.

As shown in Table 1.1 below, after almost two decades, the number of banks in Malaysia still remains relatively large.

Table 1.1: Total Banks in Malaysia

	1980	**1990**	**1997**	**1999**
Commercial banks:				
• Domestic	21	22	22	21
• Foreign	17	16	13	13
Finance Companies	47	45	39	25
Merchant Banks	12	12	12	12
TOTAL	**97**	**95**	**86**	**71**

Source: Bank Negara Malaysia, 10 August 1999

In February 2000, BNM gave approval to consolidate the country's fifty four domestic financial institutions under ten "anchor" banks. The plan expanded on an earlier, controversial, directed merger program under which domestic institutions had been told to merge under six pre selected anchor banks. This merger process was completed by March 2003 (with the operational integration between RHB Bank Berhad and Utama Bank Berhad) and the ten anchor banks still stand as of today. Although managing to take huge steps forward, one can argue to support the former Governor's claims of a slow banking merger pace, when comparing Malaysia to a more mature economy such as Singapore, which has only three local/anchor banks – DBS, UOB and OCBC. The main factors that attribute to the number of banks being reduced will be discussed next.

1.3 The Rationale for Domestic Bank Mergers

BIs merge for a variety of reasons: to increase economic efficiency, to acquire market power, to expand into different geographic markets, to enhance liquidity condition and to pursue financial synergies.

The main motivation of domestic mergers is to search for economies of scale. Scale economies is particularly important for merger of small banks, as small institutions aim to achieve a critical mass to exploit synergies arising from size and diversification.

On the other hand, merger of large banks often reflect a repositioning of the institutions involved, that is, the pursuit of size increase reflects the perceived need to become big enough for the domestic market, increasing their market power (European Central Bank, 2000). Therefore, one of the requirements to increase the size of the merged banking groups is the asset base at least RM25 billion funded by a minimum shareholders' funds of RM2 billion (BNM, 2001). The result had been proven by the ability of the domestic banks to withstand pressures and challenges arising from an increasingly competitive global environment.

In line with globalisation, the banking industry aims to be without geographic and territorial boundaries, resulting in unprecedented growth in competition, the continued liberalisation of capital flows, the integration of national and regional financial systems, and financial innovations. This further encourages domestic banks to pursue mergers and improve their acquisition strategy as they seek to outperform one another and also outperform foreign competition.

Enhancing the liquidity condition is one immediate objective of the merger exercise. The liquidity position of the Malaysian banking sector remained at 79.1 per cent in 1998 and rose to 80.3 per cent in 2000, upon the completion of the merger and consolidation exercise (Malaysian Institute of Economic Research, 2002).

Mergers are structured in such a way as to reap maximum synergy from the merger to improve the profitability and efficiency of the proposed banking groups. Synergy via mergers is supposed to result in better performance than either the target or the acquiring firm was able to attain individually.When acquiring Delta Finance Berhad in 2000, RHB was looking to synergise its already strong banking network with a leading regional finance company in East Malaysia Delta Finance had a network of twenty two branches, of which sixteen branches cover all major economic areas of Sabah and Sarawak. As such, Delta Finance Berhad provided RHB Bank with a stronger platform in East Malaysia to expand its customer base in hire purchase and assets based lending as well as strengthen the bank's existing financial services network.

In Malaysia, the single most important underlying force driving the merger wave is the extraordinary advancement in communications and data processing technology over the past two and a half decades, resulting in the number of banks being decreased from ninety seven to what it is now. Advancements in database-management software made it easier to automate record-keeping, provide widespread access across branches and ATMs, making it much cheaper to run the core businesses of the bank. This benefit is most felt when a bank has a larger customer base and has a wider coverage area in terms of its branches. With improvements in technology back-office operations like data processing, billing and statement generation become cheaper as a bank's customer base increases. In contrast, a smaller bank with a smaller customer base might not be able to afford or it may not be as cost effective to invest in upgraded software. In the end, only financial giants will be able to afford investing in future technology. Without BNM stepping in to intervene, it would be unlikely that the smaller banks stay in business or stay profitable and the larger banks would be able to offer similar products at cheaper prices.

To follow on the above point, another reason for bank mergers in Malaysia is the creation of so-called financial supermarkets or “one-stop” bank. As consumers become more mature, they appreciate the convenience of being able to do all their banking at one place. In line with consumer demands and again for the sake of saving costs central bank's consent to the new groupings paves the way for a strong, efficient and competitive banking sector which will be able to handle the onslaught of globalisation and liberalisation. Each anchor bank in Malaysia now consists of at least a commercial bank, a finance company and a merchant bank in its group. A customer can now have all his/her needs taken care of from traditional bank products, to credit cards, to personal and business loans, insurance, share trading and even wealth protection services such as will writing. Before, a consumer might have had to go to two, three or maybe even four different banks/institutions for all of the above instead of just one.

1.4 Merger Theories

Both mergers and takeovers (acquisition) have an ultimate purpose, which is designated for organisational growth. All mergers and takeovers represent a change in ownership and require willingness of the majority of the shareholders to accept the terms of the offer.

However, there are differences between mergers and hostile takeovers. Although hostile takeovers are not discussed in this paper’s discussion, it’s still important to understand its difference from mergers. Mergers are the combination of two or more businesses in which all but one legally cease to exist and the combined organisation continues under the original name of the surviving firm. Basically, mergers involve agreed amalgamation between two or more firms. Some times, the two merged firms form a new entity that operates under a new title.

On the other hand, hostile takeovers involve the stock of the firm that goes out of existence (target firm) being acquired by the continuing firm. It is also very common that the acquiring firm has met resistance in acquiring the shares of the target firm and most likely, the continuing firm will keep its name. Especially common in the 1980s, hostile takeovers have become highly controversial. Some contend that they bring needed infusions of capital and efficiency to the targeted company. Others argue that, having borrowed heavily to finance the merger, the buyer is forced to sell valuable assets of the targeted company to pay off its debt.

This paper focuses more on friendly mergers/takeovers and its effect on the merged firms. Thus, some characteristics more associated with hostile mergers will not be discussed when showing the effects of merger between two firms.

1.4.1 Differential Efficiency

According to the differential efficiency theory of mergers, if the management of firm A is more efficient than the management of firm B, and if after firm A acquires firm B, the efficiency of firm B is brought up to the level of firm A, then this increase in efficiency is attributed to the merger.

According to this theory, some firms operate below their potential and consequently have low efficiency. These firms may be targeted by other firms in the same industry for acquisition as they may be operating below its full potential. If the acquiring firm is well managed, it may be able to transfer its practices to the target firm thus increasing it efficiency and profitability.

However, difficulties would arise when the acquiring firm overestimates its impact on improving the performance of the acquired firm. This may result in the acquirer paying too much for the acquired firm. Alternatively, the acquirer may not be able to improve the acquired firm's performance up to the level of the acquisition value given to it.

This theory is important as it is one of the primary measures as to whether a merger is successful or not – whether the larger firm is able to transfer its strengths and efficiencies over to the target firm.

1.4.2 Managerial Synergy

The managerial synergy hypothesis is an extension of the differential efficiency theory. It states that a firm, whose management team has greater competency than is required by the current tasks in the firm, may seek to employ the surplus resources by acquiring and improving the efficiency of a firm, which is less efficient due to lack of adequate managerial resources. Thus, the merger will create a synergy, since the surplus managerial resources of the acquirer combine with the non-managerial organisational capital of the firm.

When these surplus resources are indivisible and cannot be released, a merger enables them to be optimally utilised. Even if the firm has no opportunity to expand within its industry, it can diversify and enter into new areas. However, since it does not possess the relevant skills related to that business, it will attempt to gain a 'toehold entry' by acquiring a firm in that industry, which has organisational capital along with inadequate managerial capabilities.

Again, this theory will help discuss if mergers actually improve the performance of banks in Malaysia as it involves whether surplus resources is used effectively to increase profitability of the merged group.

1.4.3 Financial Synergy

The managerial synergy hypothesis is not relevant to the conglomerate type of mergers. This is because a conglomerate merger implies several, often successive acquisitions in diversified areas. In such a case, the managerial capacity of the firm will not develop rapidly enough to be able to transfer it efficiency to several newly acquired firms in a short time. Furthermore, managerial synergy is applicable only in cases where the firm acquires other firms in the same industry.

Financial synergy occurs as a result of the lower costs of internal financing versus external financing. A combination of firms with different cash flow positions and investment opportunities may produce a financial synergy effect and capacity may be greater than the sum of their individual capacities before the merger.

For an excellent case study for in financial synergy, we look again at the DCB-Kwong Yik bank merger. Before the merger took place, many were talking about large external borrowings needed to fund this move. However, in November 1996, Rashid Hussain Bhd (RHB) said that the 75 per cent acquisition of KYB at RM8.80 per share (total RM2.16 billion) would be initially funded through internal funds and bank borrowings.

Part of the borrowings would then be refinanced with proceeds raised from new share issues to Malaysian Resource Corporation Berhad (MRCB). It would also issue RM800 million in bonds due in 2002 with about 54.5 million warrants due the same time. The merger deal also involved the issue of new shares for both merger parties which in total generated more than 1 billion.

Shortly after, RHB Securities (RM3.4 billion) was acquired along with RHB Bena Sdn Bhd (RM6 million) which was used as vehicles for its purchase of the majority stake in KYB.

Resulting from this exercise was RHB Capital eventually owning 1.046 billion shares in KYB representing 92.75 per cent of the enlarged and paid up capital of KYB. This resulted in RHB enjoying a higher net tangible asset per share as well as a stronger and more diversified group. Through this series of successive mergers and acquisitions, RHB was able to take advantage of cash flow positions of several companies and use them to invest in other businesses/companies to ultimately create a financially stronger group.

The financial synergy theory also states that when the cash flow rate of the acquirer is greater than that of the acquired firm, capital is relocated to the acquired firm and its investment opportunities improve. Looking at the example above, it can be said that even the acquired firm can "technically" relocate its funds to assist the acquiring company – RHB Bena (which belongs to RHB Capital) used to purchase KYB.

1.4.4 Operating synergy

The operating synergy theory of merger states that economies of scale exist in industry and that before a merger takes place, the levels of activity that the firms operate at are insufficient to exploit economies of scale.

Operating economies of scale are achieved through horizontal, vertical and conglomerate mergers. Operating economies occur due to indivisibility of resources like people, equipment and overhead. The productivity of such resources increases when they are spread over a large number of units of output. For instance, expensive equipment in manufacturing firms should be utilised at optimum levels so that cost per unit of output decreases.

Operating economies in specific management functions such as production, research and development (R&D) and marketing of finance may be achieved through a merger between firms, which have competencies in different areas. For instance, when a firm, whose core competence is in R&D merges with one that has a stronger marketing strategy, the two businesses would complement each other.

Operating economies are also possible in generic management functions such as planning and control. According to the theory, even medium sized firms need a minimum number of corporate staff. The capabilities of corporate staff responsible for planning and control are underutilised. When such a firm acquires another firm, which has just reached the size at which it needs to increase its corporate staff, the acquirer's corporate staff would be fully utilised, thus achieving economies of scale.

Vertical integration that is, firms combining at different stages of the industry's value chain also helps achieve operating economies. This is because vertical integration reduces the costs of communication and bargaining.

1.4.5 Pure Diversification

Diversification provides several benefits to managers, other employees and owners of the firm as well as to the firm itself. Moreover, diversification through mergers is commonly preferred to diversification through internal growth, since the firm may lack internal resources or capabilities required.

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For example, when DCB Bank merged with Kwong Yik Bank to form RHB Bank, Rashid Hussain was looking to add Kwong Yik Bank's expertise and retail strength in small to medium enterprises to DCB Bank's corporate and multinational know-how. At the end of the financial crisis of 1997, RHB Bank Berhad became Malaysia's third largest bank and was able to make headway in more financial sectors as compared to before.

If pure diversification can be achieved without excessive costs to produce profit, then bank mergers would definitely be an advantage to both merging parties by allowing the new entity to be able to compete with other companies that specialise in traditional bank related businesses.

1.5 Conclusion

The outcome of the research will be crucial in drawing a conclusion on how successful BNM was in implementing steps to ultimately strengthen the local banking sector for long-term survival via bank mergers and consolidation. So far, only the history and reason for bank mergers along with several merger theories have been discussed. Although, some of the examples above highlight the accuracy of the merger theories, we need to go deeper and conduct a more complete analysis into the effects of bank mergers, particularly where the numbers lie, in order to determine if mergers really do increase performance and profitability.

The next chapter conducts literature review on the performance of the bank mergers.