Chapter 2

Review of Relevant Literature

2.1 Introduction

The purpose of this section is to briefly summarise the general results of the various strands of research, which have studied the phenomenon of mergers. The following section contains material from various sources that will help us have a better understanding on performance of mergers – traits such as efficiency, returns, profitability are mentioned to offer some insight on what factors affect the performance of mergers.

2.2 Performance

Tan Sri Dato' Sri Dr. Teh Hong Piow, chairman and founder of Public Bank Berhad mentioned that as the process of liberalisation of the Malaysian banking sector continues and in an increasingly competitive environment, it is expected that market forces will be the key to further consolidation and mergers in the Malaysian banking sector (Global Finance, Jan 2003).

In Sufian, F's paper on the efficiency effects of bank mergers and acquisition, he found that Malaysian banks have exhibit a commendable overall efficiency level of 95.9 per cent during 1998-2003 hence suggesting minimal input waste of 4.1 per cent. His results suggest that the merger programme was successful, particularly for the small and medium size banks, which have benefited the most from the merger and expansion via economies of scale. On the other hand his results suggest that the larger banks should shrink to benefit from scale advantages. This paper utilises the non-parametric frontier approach, Data Envelopment Analysis (DEA), to analyse the technical and scale efficiency of domestic incorporated Malaysian commercial banks during the merger year, pre and post merger period (Sufian, F, 2004).

The Malaysian banking system recorded a significant increase of 107.5 per cent in pre-tax profit for the calendar year 2000 after the merger process took off with increased ROA to 1.5 per cent from 0.7 per cent in 1999. Consequently ROE increased significantly from 9.8 per cent in 1999 to 20.4 per cent in 2000 providing the testimony that the banking system has recovered and there was perceived improvement in productivity. The mergers seem to have eliminated excess capacity more efficiently than bankruptcy or other means of exit in part preserving the financial institutions products and services (Bala Shanmugam and Mahendran Nair, 2003). However, there was a 2 per cent reduction in net interest income in 2001 with a decreased ROA to 1.1 per cent and ROE decreased to 14.5 per cent (BNM, 2001).

There has been extensive research on the economic performance implications of mergers and acquisitions. Early research, for example, Berger and Humphrey (1992, 1994), DeYoung (1997), Rhoades (1993) and Peristiani (1997) suggest that many banks engage in mergers for the purpose of improving efficiency. However, empirical studies on bank mergers do not support this claim. DeYoung (1997) finds that 58 per cent of a sample of 348 deals in 1987 and 1989 generates small cost efficiencies. In Rhoades (1998) research, it suggested that the cost efficiency effects of mergers may depend on the motivation behind the mergers and the consolidation process.

Almost all of the studies that find no gain in efficiency also find no improvement in profitability. In contrast, the studies that report at least some evidence of performance improvement do not obtain consistent efficiency and profitability results, or they are unique in some respect, or both. For example, Spindt and Tarhan (1992) find some improvement in return on equity (ROE) from bank mergers but no significant improvement in return on assets (ROA) or cost efficiency (non-interest expenses divided by total assets). Corentt and Tehranian (1992) compare pre merger and post merger performance of thirty large bank holding companies occurring between 1982 and 1987. They find that cash flow returns, relative to a national group of publicly traded banks that did not engage in merger activity, improve following mergers. They also find that ROE improves, but not ROA. Spong and Shoenhair (1992) find evidence of an improvement in overhead cost efficiency following bank mergers but generally no improvement in ROA or ROE. On the other hand, Peristiani (1993) finds some improvement in ROA following mergers but generally no improvement in cost ratios and efficiency measures. Spindt and Tarhan (1993) find that mergers do exhibit operating gains, but their results may be due primarily to economies of scale.

More recently, Rhoades (1998) compared bank profitability ratios, such as ROA or ROE before and after mergers relative to peer groups of banks that did not engage in mergers. He finds improved profitability ratios associated with bank mergers. On the other hand, others find no improvement in these ratios (Pilloff, 1996, Akhavein, Berger, and Humphrey, 1997).

Pilloff (1997) finds no significant change in post-merger ROE. However, when he utilises operating income before provisions instead of net income to calculate ROE, there is a significant increase in post-merger returns. He finds that managers often overestimate their ability to manage newly acquired assets and sometimes overbid. Peristiani (1997) finds no improvement after merger, although he finds that the merged banks out-performed the combined results of the buyer and the target before the merger. Houston, James and Ryngaert suggest that most of the estimated value gains from bank mergers stem from the opportunity to cut costs by eliminating overlapping operations and consolidating backroom operations (Penas, Maria F. and Unal H., 2003).

According to Dymski (Dymski, 1999), mergers may thus be desirable for banks if they are expected to enhance the acquiring bank's capacity to increase profits, independent of the effect they may have if any on operational efficiency. Since there is some support for the hypothesis that links market power and profits in banking market – according to the finding of Berger (1995) – this result suggests that "banks may use mergers as a way of seeking out market power, so as to enhance their ability to generate net profits". Again, RHB demonstrated the benefits of a successful merger when it completed its union with Bank Utama Berhad in May 2002. By minimising operational hiccups (the key to this merger), they were able to achieve a wider geographical network of outlets and customer segments. For the financial year ending 30 June 2003, fourteen months after the merger with Bank Utama, RHB Bank Berhad's Net Profit nearly doubled (RM253million from RM155million in 2002) and their ROE after taxes jumped from 3.3 per cent to 6.7 per cent. Earnings per share also nearly doubled to 5.6 cents per share in 2003.

However, Deyoung and Nolle (1996) indicate that cost-based analysis might misrepresent the nature and the extent of inefficiency in banks. For instance, banks might create more revenue by increasing costs. Thus, revenue efficiency might lead to cost inefficiency. Unless revenue efficiency overcomes cost inefficiency, banks will not be more profitable. Berger and Mester (1999) as well as Berger and Deyoung (2002) recommend profit maximisation being superior to cost minimisation for the study of firm performance because profit function more completely deals with the economic goals of a firm and its owners, who takes revenue into account as well as costs. However, in this research, it is found that there is equally important to analyse both cost efficiency and profit efficiency in order to have a better coverage of both different sides of operating cost saving and operating profit improvement generated by an effectiveness merger plan. If a merger only result to an increase of operating profit with an increase of operating cost, (a decrease of cost efficiency), or vice versa, is not an effective merger. A merger is said to be effective and successful if it is able to achieve better cost efficiency, leading to higher profits.

2.3 Conclusion

Despite continuously ongoing research on bank mergers, we still know surprisingly little about whether and how bank mergers improve efficiency at large. Overall, the operating performance studies provide substantial evidence that bank mergers do not generally yield performance improvement, in terms of either profitability or cost efficiency. We also take with us several key learnings from the excerpts above;

- External market forces can help dictate the outcome of mergers. A growing or slumping economy can have a positive or negative effect on bank mergers. For example, with the increasing consumer awareness and increasing number of "smart" consumers who cry out for innovative products and more solutions from one bank, bank mergers definitely help anchor banks provide more solutions as they have more expertise under their wings acquired from the mergers. In 2000, Maybank became the first bank to offer internet banking. This after the acquisition of Phileo Allied Bank, a pioneer of online banking services in Malaysia to suite customer demands for more convenient way to bank.
- The size of the merging entities also has a part in determining the outcome of the merger. Obviously, it's the smaller banks that have the most to gain from scale of economies of operations (e.g. outsourcing certain operations). However, smaller banks tend to have expertise in certain niche areas that could be helpful to the bigger entity for future business development.
- The motivation behind the merger also is important. Merging entities must have synergies (as discussed in Chapter 1) such as the RHB merger in order to make a merger more profitable.
- We talked again and again about the efficiency after the merger, particularly operational efficiency. Being able to transfer processes, know-how and to get buy-in

from old employees of the merged bank must be done quickly in order to reap maximum benefits from a merger. Dato' Sri Sulaiman Abdul Rahman Taib of RHB Bank Berhad said when RHB merged with Bank Utama – "you can expect hiccups in operations with a merger of this magnitude but the issues are being addressed and we will be very competitive in the upcoming year".

The next chapter gives an overall view on the recent bank mergers in Malaysia.