CHAPTER 1 : INTRODUCTION

1.1 General

This study addresses the performance consequences of firm-level strategic similarity of institutionalized local commercial banks in Malaysia. The purpose of this study is to investigate whether the local commercial banks with similar resources requirements will achieve better performance through balancing the pressures of competition and legitimacy.

From the study of strategic management theory, differentiations reduce competition. From the study of population ecology and institutional theory, conformity enhances legitimation. Past research observed that organizations face pressures to be different in order to reduce competition and to be the same to demonstrate their legitimacy; research results imply that both reduced competition and legitimacy improve performance.

The approach of this study builds on theory of strategic balance by synthesizing the differentiation and conformity perspectives (Deephouse, 1999), which focus on the relationship between strategic similarity and performance through the mechanisms of competition and legitimacy. The theory's main recommendation is that organizations seeking competitive advantage should be as different as legitimately possible.

1.2 Theoretical Background

Within an institution, an institutional linkage is defined as direct and regularized relationship between an organization and an institution in the organization's environment. Institutions are defined as government or community constituents in the organization's task environment that possess either community-wide and uncontested social acceptance or legislative and administrative authority in the organization's domain. (Baum and Oliver, 1991)

Strategy is conceptualized as an organization's realized position in its competitive market (Mintzberg, 1987; Porter, 1980) each organization's strategic position is supported by its resources and capabilities (Wernerfelt, 1984).

Organization's relative strategic position with other competing organizations is the important factor to be considered in the study of organization's performance, as implied by organizational ecology theory (Hannan et al., 1990), institutional theory (DiMaggio and Powell, 1983) and strategic management (Barney, 1991; Porter, 1980);

Population ecology theory suggests that organizational survival is the result of environmental pressures that differentially select adaptive forms for retention in an organizational population. Among the environmental selection criteria that population ecologists have elaborated are external pressure for legitimacy and the forces of competition and institutionalization in organizational populations (Hannan and Freeman, 1984, 1989; Baum and House, 1990). Competition occupies a central role in ecology theory. Under competitive conditions, organization's survival is depended on organization's ability to obtain scare resources, the enhanced ability of institutionally linked organizations to mobilize resources and social support is expected to provide survival advantage over unlinked competitors.

Institutional theorists have proposed that an organization is more likely to survive if it obtains legitimacy, social support and approbation from external constituents of its institutional environment. This external conformity elevates the organization's status in the community, facilitates resource acquisition and deflects questions about an organization's rights and competence to provide specific products or services. (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Meyer and Scott, 1983)

Both institutional and ecological frameworks thus suggest that institutional relations/legitimacy improve organization's performance and survival prospects.

The basic argument of strategic management is that an organization with different strategy benefits because it faces less competition for resources. Strategic management theory suggests that an organization that conforms to the strategies of others has many similar competitors that limit the performance of the organization and increase failure rates (Baum and Singh, 1994; Hannan *et al.*, 1990; Henderson, 1981). The organization targets similar market resources using similar competencies, the situation approaches perfect economic competition where economic rents equal zero (Porter, 1980, 1991). Hence, strategic management theory that emphasizes the differentiation strategy on organization's performance is contradicts with population ecology and institutional theory.

Deephouse (1999) address the contradiction between strategic management theory and population ecology and institutional theory by developing an integrative theory of strategic balance. The theory of strategic balance addresses relations among strategic similarity, competition, legitimacy and performance. Differentiation and conformity propositions were synthesized into the strategic balance proposition, which states that moderately differentiated organizations have higher performance than either highly conforming or highly differentiated organizations.

1.3 Scope of the Study

This study provide theoretical background and statistical support to the theory of strategic balance (Deephouse, 1999) in addressing performance consequences of firm-level strategic similarity of institutionalized local commercial banks in Malaysia. Strategic balance theory suggests that intermediate levels of differentiation where organizations balance the benefits of reduced competition against the costs of reduced legitimacy will improve organization's performance.

The strategic decisions of local commercial banks examined are asset allocation decisions, which are measured by a set of selected strategic variables. The empirical study is focused on the relationship between return on asset and strategic similarity of competing local commercial banks in Malaysia.

Empirical analysis is carried out using secondary data from annual balance sheet and financial statement of local commercial banks. A set of strategic variables is selected to construct the strategic deviation (independent strategic variable), which reflects the relative strategic position (strategic similarity) of each commercial bank. An equation is used to generate a general relationship between dependent variable (return on asset) and independent strategic variable (strategic deviation) in combination with other dependent and independent control variables. Statistical analysis using hierarchical multiple regression method is used to examine the relationship.

The statistical analysis examines whether the inverted U-shape (curvilinear) relationship exist between return on asset and strategic deviation. The analysis then investigates whether the curvilinear relationship receives stronger empirical support than linear relationship.

The existence of inverted U-shape relationship and stronger empirical support of curvilinear relationship than linear relationship in the above analyses is concluded as strong support to the strategic balance theory.

1.4 Limitations and Assumptions of the Study

The study of strategic balance theory developed here limited to local commercial banks in Malaysia as for-profit organizations in an established market within a structurated organizational field (Deephouse, 1999), using one industry in one market controls for differences across industries and localized business conditions.

The study assumes that strategy is related to the competitive environment and institutional environment. Organizations in an established market compete with each other for both customers and suppliers. Organizations in a structurated organizational field face institutional pressures from government regulators, professional associations and social networks. The study assumes no strategic group (Reger and Huff, 1993) in this market and that local commercial banks do not collude.

In this study, the analysis of organization's performance is focused on firm-level strategic similarity, which is assumed to represent organization differences. Strategic similarity is constructed using a set of selected strategic variables by combining each deviation of strategic variables into strategic deviation. Hence, local commercial banks can have same level of similarity but not have the same level of set of strategy variables.

Organization's performance is defined as the net flow of resources in term of return on asset, which is a covering term representing competitive advantage, survival, social and economic fitness, etc. The study assumes that organizations with persistent net resource outflows will eventually fail.

The study assumes local commercial banks interact actively in both organizational field (consists of a network of competitors, suppliers, customers, regulators, trade associations etc) and general environment (consists of other organizations outside the organizational field and sociocultural, technological, economic, and other trends).

Strategy researchers using a cognitive perspective suggested that managers in an industry develop a cognitive consensus about what strategies are proper and reasonable. This study assumes that strategies can be legitimated by institutional forces in both organizational field and general environment. Managers in local commercial banks are assumed to be organizationally rational, they select and implement strategies that they think will lead to higher performance.

Local commercial banks are assumed not powerless in the face of institutional forces. Therefore, local commercial banks can resist the attempt to influence them. Local commercial banks are assumed to be price-takers on cost side and also for other costs of doing business, such as rent and wages, because they compete in a market with organizations of all type for office space and employees.

The study assumes that other determinants of competition, legitimacy and performance are assumed constant in order to focus on the role of strategic similarity.

1.5 Organization of the Study : Local Commercial Banks

The population used in this study is local commercial banks competing in Malaysia.

The commercial banks are the main players in Malaysia banking system. They are the largest and most significant provider of funds in the Malaysia banking system with total loans and total deposits amounting to RM 285.1 billion and RM 287.6 billion respectively, as end-June 1999, representing approximately 76% and 71% of the banking system's total loans and deposits, respectively.

In general, commercial banks serve as financial intermediaries, channeling money from investors (sources of supply) to borrowers (sources of demand). Local commercial banks through its institutional link under the supervision of Bank Negara Malaysia (BNM) also play central roles in the payment system and in the implementation of national monetary policy.

Local commercial banks are operates in structurated organizational field and thus face strong institutional forces from many sources. Because of their crucial roles in the economy, local commercial banks are highly regulated. Local commercial banks were initially brought under supervisory control via the Banking Ordinance 1958 (later known as the Banking Act 1973) with the establishment of BNM, the commercial banks had only to comply with Companies Ordinance 1948. The Banking Act 1973 was subsequently replaced in 1989 with Banking and Financial Institutions Act 1989 (BAFIA), which combines the Banking Act 1973 and the Finance Companies Act 1973 and the Finance Companies Act 1969 under a single legislation.

Some of the major influences of BAFIA and institutional forces on the strategy setting in local commercial banks' business operations are: -

- BAFIA states that banking business can only be carried out by a public company which holds a valid license granted by the Minister of Finance on the recommendation of BNM.

- With the aim of rebuilding and strengthening the balance sheet of commercial banks, prudential reforms were introduced. The most significant was the implementation of Risk Weighted Capital Ratio (RWCR, known as Bank for International Settlements (BIS) capital adequacy framework in 1989). Under RWCR framework, investments in the subsidiaries are deducted from the capital base of the parent banks, thereby reducing their RWCR.

- BNM has strong influence over base lending rate (BLR) computations. The computation of ceiling BLR was refined in September 1998 by substituting the weighted average interbank rate with the intervention rate. The intervention rate (decided by BNM) was used as a basis to compute the ceiling BLR as it is the rate at which banking institutions can borrow from BNM at times when the market is short of liquidity.

- Implementation of two-tier regulatory system (TTRS) for commercial banks in 1994 and its abolishment in 1999.

- Commercial banks are also required to achieve a strong rating under the CAMEL framework by BNM, which evaluated five critical components of banking operation i.e. capital adequacy, asset quality, management capability, earnings performance and liquidity position.

- In line with the socio-economic objectives of the Malaysia government, BNM has taken steps to ensure that the identified group of borrowers, such as the Bumiputera community, the small and medium scale enterprises and prospective house owners from the lower middle income group, continue to have access to credit at reasonable cost from the banking institutions.

Towards this end, specific guidelines on the direction of bank lending known as the Lending Guidelines to the priority Sectors are reviewed and issued periodically to meet the growing needs of the economy. This Lending Guidelines serves as measures for BNM to directly affect the end use of bank funds

- BNM also imposes other operation requirements on commercial banks such as to maintain a minimum amount of liquid statutory reserve requirement, issuance of negotiable instrument of deposits, liquidity requirements, total eligible liabilities computation and a series of prudential standards and regulation.

Fundamental strategic decisions of a commercial bank are the selection of assets and liabilities (Santomero, 1984). Commercial banks need to make a set of strategic decisions on the allocation of resources to certain product markets, such as construction lending, real estate lending, consumption credit, etc. Commercial banks in Malaysia market offer similar products to similar customers and compete for similar factors of production. Commercial banks compete among themselves to extend loan to profitable sectors, compete for the loan officer who makes the loan; and compete for deposits to fund the loan. Thus, commercial banks face strong competitive forces in market.

Due to the nature of competitive market, local commercial banks may emphasize differentiation strategy in the business operations. For instance, a successful bank that perceived unexploited opportunities in certain sector will penetrate in that sector in big way to establish a distinct position with competitors. The economic rent is likely to be more favorable of lesser competition. The favorable economic rent will attract other in that sector, thus driving down profit margins. The successful bank would rely on its skills in identifying and capitalizing on the next underexploited sector. In the process, it would reestablish its distinct position.

However, there is evidence for mimetic isomorphic pressures in the selection of asset strategies by commercial banks. There is some degree of uncertainty about which assets and economic sector will fail to make future payments. Spong (1990: 11) pointed out that bank regulation does not substitute regulatory strategic decision-making for bank strategic decision-making. Instead, strategic norms develop through regular interactions among banks in the institutional processes. If commercial bank planned to deviate from the guidelines set by BNM in certain business operation, the bank need to notify BNM. Banks that didn't conform to standard industry strategies also were subject to legitimacy challenges in the media (e.g., Loomis, 1992).