

CHAPTER 1

INTRODUCTION

1.1 Objective/Scope of the Study

The financial crisis of 1997 that affected the East Asian countries also affected Malaysia and among others it showed the weaknesses and vulnerability of the banking system. There was an immediate need to institute measures to strengthen the financial sector particularly the banking sector. Weaknesses in the banking sector and over reliance of the economy on this sector further enhanced the need for drastic measures to strengthen the sector.

One of the strategies undertaken to strengthen the banking sector is the **consolidation directive** to make the banks bigger and thus more resilient to face competition and challenges. In opting for the consolidation strategy, Bank Negara Malaysia (BNM) hoped to place the banking industry in a stronger footing to withstand competition. Since the early 1990's, BNM has been encouraging banks to consolidate in anticipation of liberalization and globalization. A two tier regulatory system that sought to provide incentives for smaller banks to recapitalize and merge was introduced in 1994. In March 1998, BNM required all finance companies to merge with the larger ones to be absorbed by their bank holding companies. In July 1999, this directive was extended to cover all commercial banks.

These moves was seen as the start of BNM's move to develop a core group of strong and well-capitalized banking system that will be able to compete effectively in a more liberal and open environment by the time liberalization is implemented in the financial sector in the year 2003. In the era of globalization, banks have to merge to withstand competition especially in the face of increasing pressures under WTO for countries to open up their financial markets for further entry of foreign banks.

The bank merger program hopes to facilitate the absorption of the weaker financial institutions (FI) instead of closing them down as well as encourage or coerce the consolidation of the other local FIs to increase the scale and scope of operation of the merged entities as "universal" banking groups. It is envisaged that these will thereby improve their efficiency as well as their ability to compete in particular against foreign banks. The merger program is aimed at developing a core of large and viable domestic banking groups, which will maintain and if possible, develop the local and bumiputera share in the Malaysian banking industry.

In July 1999, BNM announced a specific merger program for banks. BNM named 6 banks namely Maybank, Bumiputra Commerce Bank, Public Bank, Affin Bank, Multi Purpose Bank and Southern Bank as anchor banks. BNM had also chosen their supposed merger partners. In October 1999, BNM revised its stand and announced that it was willing to consider proposals for mergers from

other aspiring core banks. In February 2000, BNM announced that there would be 10 anchor banks. In addition to the 6 original banks, the 4 new ones were RHB Bank, Arab-Malaysia Bank, Hong Leong Bank and EON Bank.

One of the main areas of concern in the consolidation directive by BNM was the choice of the anchor banks. This study will attempt to provide some economic basis for the choice of the 10 banks as anchor banks as these will be the 10 remaining core domestic banks from the year 2001. These 10 banks will play the major role in the success of the financial sector especially when the sector is liberalized from the year 2003 and competition from the foreign banks becomes more intense.

1.2 Methodology

Relevant data was collected for the period 1980-2000 to analyze the past performance of the banks. Studies on bank consolidation such as by Allen N. Berger 1994, ("The consolidation of the Financial Services industry: Causes, consequences and implications for the future"), Stephen Rhoades 1994, ("A Summary of Merger Performance Studies in Banking, 1980-93, and an Assessment of the "Operating Performance" and "Event Study" Methodologies") and by Gerald A Hanweck 1999, ("The bank merger movement: Efficiency, stability and competitive policy concerns") were reviewed to understand the reasons and rationale involved in consolidation. Macro data on the banking

industry in Malaysia was also analyzed in this study. Analysis was done on the past performance of the anchor banks to gauge the possible rationale for their choice. Comparisons were made with the performance of the non-anchor banks and also foreign banks where appropriate.

Data were obtained mainly from the KLSE Company handbook, KLSE on disc, BNM annual and monthly reports, Bank Annual reports and the Bankers Directory. These data sets were obtained from the BNM library, the Public Information Center in the KLSE and bank and BNM websites. These data is also supported by information from publications and studies done by the local research houses and also specialized journals like the Bankers Journal, Capital Markets Review and magazines and newspaper reports on progress in bank mergers.

1.3 Limitations and Problems

The bank consolidation exercise was seriously mooted as one of the strategic response to the problems of the banking industry immediately after the crisis of 1997/98. The reasons for the merger has been well discussed in the many of the official publications and policy speeches from senior government officials as discussed above. However, the reasons for the choice of the anchor banks have not been revealed. As a result, the criteria and the evaluation methods used to pick the anchor banks are not publicly available. Therefore, this study is limited

to analyzing published information on bank performance and makes use of some measures of evaluating bank performance to ferret out the possible reasons for the choice of the anchor banks.