CHAPTER 3

LITERATURE REVIEW

3.1 Background to the Financial Crisis

The East Asian Crisis of 1997/98 affected Thailand, Korea, Indonesia, Malaysia and the Philippines and to a lesser extent Hong Kong, Singapore and other Asian countries. Generally Thailand, Korea, Indonesia and Malaysia have been singled out for study as they were most affected by the crisis.[i] However, in the case of Malaysia, the fundamentals were relatively better than Thailand, Korea and Indonesia. Nevertheless, interest in Malaysia's responses has attracted special attention due to the policies adopted without the aegis of the IMF-World Bank structures.

The policy responses can be divided into what is loosely called the IMF-World Bank type of response and the unorthodox experimentation with capital controls in Malaysia. Both measures had brought about a measure of economic recovery. The policy response of the Malaysian government is interesting in its unconventional approach to economic and financial policy making in the face of a crisis. These include the introduction of capital controls and the pegging of the Malaysian Ringgit to the US dollar. Both outflow and inflow of capital was temporarily suspended. Exceptions were made for foreign direct investments and trade related transaction. Effectively, it made the Ringgit un-tradable outside Malaysia.

However, Rudi Dornbursch (2001)[ii] points out that Malaysia's performance cannot be attributed solely to its policy measures. Malaysia entered the crisis in a relatively better state than the other countries. Ron Hood (2001)[iii] of the World Bank makes a similar argument. "On balance it [the capital controls] appears that both the benefits and the cost of the controls have been modest". On hindsight it can be said that the capital controls were introduced when the worst was over. However, at the time of imposition, the environment was very precarious and policy formulators were in no position to make the prediction that the worst was over.

3.2 The link between the Economic Crisis and the Banking Sector

The economic crisis led to serious banking and corporate sector crisis. Mackinnon & Pill[iv](1998) argue that banks and firms borrowed too much in the run up to the crisis. Un-hedged foreign currency denominated debt, maturity mismatch between foreign denominated short-term debt and local currency denominated long term-debt contributed to the vulnerability of the financial and corporate sector to external shocks.

Roubini (1998)[v] raises questions and provides some important link between the economic crisis and the banking and corporate sector. How can one rationally explain such over-investment in wrong projects? Why did the firms make such investments and borrow the funds? Why did the domestic banks lend them the funds and did not monitor the quality of the investments? Many governments in Asia were trying to maximize the rate of economic growth. Much of this growth was induced through high labor and capital inputs. Thus, it appeared that many governments in the region were pursuing economic growth targets that were excessive. Governments gave incentives (such as subsidies) to firms to invest too much and incentives to the domestic banks to borrow too much from abroad to finance investment projects by the firms.

According to Roubini (1998), banks borrowed much from abroad for many reasons, mostly related to the implicit promise of a government bail-out in case things went wrong: first, their risk capital was usually small and owners of banks risked relatively little if the banks went bankrupt; second, several banks were publicly owned or controlled indirectly by the government that was directing credit to politically favored firms, sectors and investment projects; third, depositors of the banks were offered implicit or explicit deposit insurance and therefore did not monitor the lending decisions of banks; fourth, the banks themselves were given implicit guarantees of a government bail-out if their financial conditions went sour because of excessive foreign borrowing; fifth, international banks (Japanese, American and European ones) lent vast sums of money to the domestic banks of these crisis hit countries because they knew that governments would bail-out the domestic banks if things went wrong. The American financial investors found the emerging markets providing good returns and since there was de-factor pegging to the US dollar, exchange rate risk was not a major issue. In Japan, the interest rates were low and funds flowed out to these fast growing emerging economies for higher returns.[vi]

The implication of this was banks borrowed too much from abroad and lent too much to domestic firms and the interest rate at which domestic banks could borrow abroad and lend at home was low (relative to the riskiness of the projects being financed). Domestic firms invested too much in projects that were marginal or not profitable. The firms (and the banks that lent them large sum) found themselves with a huge amount of foreign debt that could not be repaid. The exchange rate crisis that ensued made things only worse as the currency depreciation dramatically increased real burden in domestic currencies of the debt that was denominated in foreign currencies.

Paul Krugman(1998) argues that East Asian Banks operated with implicit government guarantees that allowed them to lend to high risk projects hoping to obtain "Pangloss" values[vii] (high returns in ideal circumstances). However, a former Deputy Governor of BNM has dismissed the argument saying that it does not fit the real world dynamics. " In the real world, private banks do put their own capital at risk, Governments do not guarantee all loses and most certainly, foreign banks do not expect to be bailed out. Bearing in mind that much of the lending to private enterprises were made by foreign banks, surely they were not mesmerized by the Pangloss values referred to by Krugman"[viii]

Lin See Yan (1997) offers three interrelated elements that may explain the crisis. First he concedes that euphoria lead to excesses in borrowing and this in turn led to currency and maturity mismatches; second the panic and impact of herding behavior led to the collapse of the lost of investor confidence and third the contagion that could not separate the good risk from the bad.

The above explanation by Lin See Yan addresses the symptoms of the crisis but still misses the underlying problems. Treating the symptoms now sets the stage for a recurrent and a virulent form of the disease some time in the future.

3.3 The Economy before and after the crisis

Malaysia's macroeconomic fundamentals were strong at the onset of the crisis in mid 1997. The economy was registering a high growth rate of 8.5% per annum in the years preceding the crisis. Even in the first quarter of 1997, real GDP continued to grow at 8%. Unemployment rate was at less than 3%. Inflation was low at less then 4%. The country also enjoyed fiscal surpluses. In 1996, external debt was manageable with a debt service ratio of 5.5%[ix]. As end of June 1997, the fundamentals of the economy had strengthened further.

The banking sector too, was strong with the reforms undertaken after the 1985 crisis. As at end June 1997, the average risk weighted capital ratio (RWCR) was at 12% which was higher then the 8% recommended by the Basel Accord. Net NPL's were only 2.2% of total loans and ratio of loan provision to NPL's was close to 100%.

Table 1 shows some of the macroeconomic indicators prior to the crisis: -

Table 1: Key Macroeconomic Indicators

Malaysia	1990	1991	1992	1993	1994	1995	1996	1997
Real GDP growth	9.6	8.6	7.8	8.3	9.3	9.4	8.6	7.7
Inflation	2.8	2.6	4.7	3.5	3.7	3.4	3.5	2.7
Current account balance/GDP	- 2.1	- 8.8	- 3.8	- 4.8	- 7.8	- 10.0	- 4.9	- 5.1
Central government balance/GDP	- 3.08	- 2.48	0.13	0.52	1.45	1.30	1.07	2.58
Broad money growth	18.2	24.4	18.1	23.8	15.8	18.2	23.7	9.6
Private sector credit/GDP	71.4	75.3	74.3	74.1	74.6	84.8	89.8	100.4
Unemployment	4.3	4.3	3.7	3.0	2.9	2.8	2.6	2.6

Source: Economic Reports, various issues

As Dornbursch (2001) points out, the Malaysian economy was in a much better shape that the other crisis affected countries. There was no real reason for the crisis to be exacerbated in the way it did.[x] The IMF, World Bank and ADB gave glowing report on the soundness of the Malaysian economy. Table 1 above shows relatively strong macroeconomic fundamentals of the Malaysian economy. Furthermore, the banking system was relatively strong, there was little exposure to foreign denominated debt, the low corporate debt and a capital adequacy ratio, that was higher then the Basel requirements[xi].

The bank management, supervision and the incentive systems for bank managers and corporations to take on risk may be at play in explaining the impact of the crisis on the banking sector. Paying attention to these micro level issues is critical in understanding how the merger solution adopted will overcome the inherent weaknesses in the banking system in Malaysia.

The financial system was viewed as fragile due to the high credit growth and tendency for credit to be channeled to non-tradable and high-risk sectors especially the property and equity market.

Table 2: Direction of lending of the banking sector between 1992-1997(%)

Sector	1992	1993	1994	1995	1996	1997	% Growth 1992-1997
Manufacturing	29.4	31.5	37.5	48.8	55.5	63.6	16.6
Property	48.4	53.5	58.4	73.6	95.4	139.8	23.6
Stocks & Shares	4.6	5.6	12.3	13.5	15.8	38.9	53.1
All Sectors	156.2	174.5	203.3	260.9	332.8	421.2	21.9

Distribution of increase in lending of the banking system, (RM billion) 1992-1997

Sector	Increase 1992-97	% share increase
Manufacturing	33.9	12.8
Property	91.5	34.5
Stocks & Shares	34.3	12.9
All sectors	265.0	100.0

Source: Computed from Bank Negara Malaysia , Annual Report. Various issues as quoted in "The East Asian Economic Crisis: Why was Malaysia Vulnerable?" Suresh Narayanan, et all Malaysian Journal of Economic Studies Vol. XXXIV, Special Issue (1997)

Between 1992 and 1997, the total lending of the banking system had increased by about RM265 billion. The property sector was the single largest recipient of this increase receiving nearly 35% or RM91.5 billion. Loans were given with scant attention to the risk due to competition between banks to maintain or increase their share of lending. The implicit government guarantees may have fueled such high-risk behaviors. Banks were also generous with share financing in support partly of the government's distributional goals. Banks became most vulnerable due to their overexposure to share financing and when real estate prices dropped below collateral level, and when firms faced cash flow problem many loans became NPL's and this led to a banking crisis. The average annual loan growth increased to 29.1% over the period 1995 – 1997 from 12.2% during 1992 – 1994 and from 22.6% during 1990 – 1991. Strong loan growths in 1994 – 1997, averaging 25% per annum, led to high loan exposure of the banking system. In addition, an under developed bond market also resulted in the banking system providing a significant portion of the private sector financing, thereby increasing the concentration of risk. The risk-weighted capital ratio of the banking system increased steadily from 9.8% in 1990 to 11.4% in 1993 before declining to 10.5% in 1997.

Table 3 : Banking System's Risk-Weighted Capital Ratio (RWCR(%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Sept 2001
Commercial Banks	10.6	10.5	11.6	12.4	11.3	11.1	10.8	10.3	11.7	12.8	12.2	12.3
Finance Companies	7.5	8.4	9.2	8.8	10.1	9.7	9.8	10.3	11.1	10.8	11.6	12.1
Merchant Banks	9.4	9.1	10.1	10.0	8.3	11.9	11.7	13.3	15.2	14.5	16.6	17.5
Banking System	9.8	9.9	10.9	11.4	10.9	10.9	10.7	10.5	11.8	12.5	12.4	12.5

Source: Extracted from various BNM Annual Reports

With the outbreak of the crisis, there was a massive decline in loan growth of the banking system to 1.3% in 1998 and 0.3% in 1999 induced by a collapse in aggregate demand, excess capacity and by the tight stance of macro policies initially.

In line with the collapse in loan demand and the increase in NPL, the profitability of the banking system turned negative in 1998 with pre-tax profits registering -0.3% as a percentage of average assets and -4.5% as a percentage of average shareholders funds. There has been a recovery since in banking profitability to a healthy level in 1999 and 2000.

The outbreak of the crisis led to a sizeable increase in the NPL ratio of the banking system. The size of commercial banks NPL rose from RM9.3 billion in June 1997 to RM42.2 billion in August 1998 before dropping to RM35.3 billion in September 1998. This ratio had increased from 3% in June 1997 to a high of 9.4% in August 1998 after which the definitions of NPL's were loosened.

Table 4 : Non-Performing Loans(1988-2000)

End of period		Non-performing loans (RM million)			Non-performing loans / Total loans (%)		
		Commercial banks	Finance companies	Merchant banks	Commercial banks	Finance companies	Merchant banks
1988		16,935	5,413	1,203	29.6	33.7	24.8
1989		16,554	5,713	989	24.3	28.3	17.9
1990		16,592	5,858	792	20.1	21.3	12.6
1991		15,518	5,473	647	15.7	15.8	8.7
1992		15,992	6,109	583	14.7	15.6	6.9
1993		15,171	5,832	490	12.6	13.0	5.0
1994		9,643	5,130	1,107	6.9	9.9	9.5
1995		8,932	4,285	1,103	4.9	6.6	7.8
1996		8,163	4,002	315	3.6	4.7	1.7
1997	Mar	7,978	3,842	348	3.2	4.2	1.7
	Jun	9,287	4,243	433	3.5	4.3	2.0
	Sep	9,141	5,401	458	3.4	5.1	2.0
	Dec	14,159	9,974	1,096	3.3	5.0	3.6
1998	Jan	16,746	11,088	1,563	3.9	8.0	5.3
	Feb	19,206	13,448	1,898	4.7	9.9	6.2
	Mar	22,278	14,282	1,821	5.8	10.6	5.0
	Apr	26,131	15,862	2,266	6.3	12.2	7.1
	May	28,585	17,194	2,634	6.6	13.4	8.5
	Jun	32,378	17,474	3,019	7.3	13.6	9.1
	Jul	36,864	19,238	3,800	8.3	15.8	12.0
	Aug	42,154	20,819	4,426	9.4	17.2	14.0
	Sep	35,324	13,292	3,137	7.6	9.2	8.8
	Oct	37,012	14,894	3,441	7.7	10.9	9.4
	Nov	39,202	16,092	4,059	7.9	11.8	11.5
	Dec	32,086	16,092	3,888	5.9	11.9	10.9
1999	Jan	35,093	16,545	4,348	7.2	12.3	12.0
	Feb	35,807	15,699	4,470	7.5	12.0	13.3
	Mar	32,145	15,772	4,141	6.4	12.3	11.2
	Apr	32,362	15,227	4,334	6.4	12.2	11.5
	May	33,829	14,679	4,634	6.5	11.9	12.8
	Jun	33,970	14,422	4,775	6.4	11.8	13.8
	Jul	34,018	14,538	4,242	6.4	11.4	15.1
	Aug	34,402	14,308	4,115	6.6	11.1	14.2
	Sep	34,838	13,584	3,955	6.7	10.2	13.3
	Oct	34,346	13,411	3,958	6.7	9.9	12.8
	Nov	33,649	13,675	4,021	6.4	10.0	12.8
	Dec	30,402	13,571	3,487	5.7	8.6	12.3
2000		35,441	14255	3,018	6.4	9.3	10.5

Sources: Bank Negara Malaysia, Statistical Bulletin

As a result of the crisis, banks started to take a very conservative position. Despite the injection of liquidity by the government, the loans growth plummeted. Banks were reluctant to grant new loans or roll over old ones. This started the vicious cycle of slowing down the economy. Coupled with reduced external demand, reduction in new loans and debt-servicing capability of the corporate demand was severely stressed leading to increasing non-performing loans and eroding the profitability in the banking sector. Table 5 shows the after tax profit growth of 10 listed commercial banks. It shows the drastic drop in the profitability of the banks. The drop of profitability in all the banks indicates the systemic nature of the banking crisis. This is hardly surprising given the fact a large portion of the loan assets had turned non-performing and due to loan loss provisioning made by the banks.

Table 5 : After tax profit growth of selected commercial banks.

	1996 (RM)	1997 (RM)	% Change in Profit	March 1998 (RM)	% Change in Profit
AMMB Holdings	369,368	671,562	69.43	104,092	-84.5
Ban Hin Lee Bank	59,766	62,266	4.18	17,276	-72.25
BIMB Holdings	33, 272	44,774	34.57	1,876	-95.81
Commerce Asset Holding	315,469	196,504	-37.71	41,985	-78.63
Hock Hua Bank	82,615	211,166	155.6	20,573	-90.26
Hong Leong Bank	140,290	192,674	37.34	41,644	-78.39
Maybank	1,121 m	1,374m	23.00	145,053	-89.44
Pacific Bank	85,352	55,211	-35.31	11,550	-79.08
Public Bank	556,122	400,134	-28.05	83,181	-79.21
Southern Bank	115,198	80,971	-29.71	19,101	-76.41
Average % Change			19.29		-82.40

Source: DataStream International and Bank Negara Malaysia as quoted in Obiyathullah Ismath Bacha, " Malaysia : From Currency to Banking Crisis", Malaysian Journal of Economic Studies Vol. XXXV Nos. 1&2 June/December 1998.

3.4 Policy responses to mitigate the impact of the Banking Crisis

The government initiated a number of policy responses to mitigate the impact of the crisis on the economy. Initial policy responses were similar to the IMF type of policies with falling money supply, increasing interest rate, reduction in government expenditure and measures to reduce consumer expenditure. These proved counter productive and led to a credit crunch. To stem the outflow of funds, interest rates were raised and this proved ineffective and exacerbated the already nervous markets. The Kuala Lumpur Composite Index plunged from a high of about 1200 in February to its lowest level of 264 in mid August 1997.

The second set of policy responses started with the introduction of capital controls. With the introduction of capital control in September 1998, the government sought to disengage itself and buy some breathing space to work its way out of the banking and corporate sector crisis that had unfolded.

These steps among others aimed at stabilizing the banking system in the immediate period and eventually building a stronger and more resilient banking sector over the medium and long-term period.

In mid 1998, the government took a few major steps to speed up financial restructuring of both the banking and corporate sector. Danaharta (an asset management company), Danamodal (a bank recapitalisation agency) and the Corporate Debt Restructuring Committee (CDRC) were established. These three bodies were established to remove non-performing loans from the banking system, recapitalize the weaker financial institutions and to facilitate distressed debt workouts so as to restore the confidence of depositors and to ensure the operations of viable firms.

Danaharta was established in June 1998 as an asset management company to remove NPL's with size of above RM5million from the banking sector. The NPL's were acquired at a sharp discount reflecting fair market value. Banks were permitted to write off the resulting loses over a five-year period. Banks can then concentrate on their major role as a lending agency to stimulate economic recovery. As of 31 December 2000, Danaharta had acquired and is managing NPL's with loan rights amounting to RM47.5 billion (2,835 accounts) of which RM39.3 billion loan rights were acquired from the banking sector.

Table 6 : NPLs acquired and managed by Danaharta as of 31 December 2000

	RM Billion	RM Billion	No. of Accounts
Acquired	20.39		828
Under Management	27.10		2,007
		47.49	2,835
Rejected by Financial institutions		8.03	423
Total Evaluated by Danaharta		55.52	3,258
Returned to financial institutions		0.12	6

Average discount on gross value of acquired NPLs-55%
Source: Danaharta Operation Report Six Months ended 31 December 2000

Danamodal was established in August 1998 to recapitalize and strengthen banking institutions. Danamodal's role is to inject capital into financial institution whose capital adequacy ratio is in danger of falling below minimum required levels. Table 7 shows the list of banks that have been recapitalized by Danamodal.

Table 7: Investments in Recapitalised Banking Institutions (as of 30 September 2001)

	Original Investment (RM Millions)	Repaid	Outstanding Balance	Nominees appointed
MBF Finance Berhad	2,280	0	2,280	4
RHB Bank Berhad	1,500	500	1000	3
AMMB	800	340	460	4
Oriental Bank	700	700	0	0
BSN Commercial	420	420	0	0
Arab-M'sian Finance	500	500	0	0
Arab-'sianMerchant	400	400	0	0
Sabah Bank	140	140	0	0
United Merch. Fin.	800	800	0	0
Perdana Merchant	50	50	0	0
Total	7590	3850	3,740	11

Source: Danamodal Website http://www.bnm.gov.my/danamodal/

The CDRC is essentially a steering committee where corporate debts are restructured on an informal basis between the distress companies and their creditors. This debt workout is outside the legal bankruptcy framework. The CDRC's role is to help restructure large corporate debts in excess of RM50 million.

Table 8 : Progress of CDRC cases (as at June 2001).

Quarter	Applications received (cumulative)	Total Debts (RM mil) (cumulative)	Completed Cases (cumulative)		Resolved with assistant of Danaharta		Cases Outstanding (cumulative)	
			No	Amount (RM mil)	No	Amount (RM mil)	No	Amount (RM mil)
3Q/1998	20	5,350.20					20	5,350.20
4Q/1998	36	11,028.15	2	344.50			34	10,683.65
1Q/1999	52	26,018.52	4	1,153.30			44	24,015.37
2Q/1999	62	33,039.64	10	10,249.40	2	954.30	42	19,782.37
3Q/1999	63	35,024.65	11	11,234.89	2	954.30	36	19,576.11
4Q/1999	66	35,652.77	13	11,778.29	2	954.30	28	16,651.13
1Q/2000	68	36,519.20	17	13,106.84	2	954.30	26	16,399.17
2Q/2000	71	39,643.01	23	17,392.49	2	954.30	21	15,660.05
3Q/2000	75	45,938.82	28	23,085.17	2	954.30	18	16,013.24
4Q/2000	75	47,209.75	31	25,476.92	2	954.30	12	11,139.10
1Q/2001	75	47,209.75	33	25,816.2	2	954.30	10	10,799.20
2Q/2001	75	47,378.75	33	27,576.92	2	954.30	8	9,208.10

Source: CDRC Reports

The **consolidation/merger of financial institutions** was another major strategy to strengthen and make the Malaysian banking industry withstand external pressures as well as to remedy weaknesses in the banking sector, to provide more incentives for investment and to improve operational efficiency. The proposal to consolidate the existing financial institutions into 10 banking groups represent an important step to transform the sector towards meeting the new challenges as well as the objective of supporting sustainable economic growth. It is envisaged that institutions that are well capitalized will be able to enjoy economies of scale while allowing them to have greater investment in information technology to remain competitive and efficient. A strong, efficient and stable banking system is a prime pre-requisite for sustainable economic recovery since only a viable and resilient banking system can allocate and mobilize domestic resources effectively and efficiently within the economy. It was evident during the recent financial crisis that a fragmented banking sector is highly vulnerable to shocks and leads to systemic risk to the banking sector. The merger solution is expected to place the banks on a stronger footing. It is expected to address some of the internal factors of bank management that is presently considered weak.

3.5 The need for mergers in the banking sector an overview[xli]

3.5.1 Challenges from Competing Institutions

Banks role as a financial intermediary is being challenged by the rise of other financial institutions like the mutual funds that are able to mobilize funds from households and corporations. In addition to the capital markets, the development of private debt markets and commercial paper markets provide an alternative and cheaper avenue for external financing for firms. With cheaper cost of computing and communications, these new financial institutions are offering services that allow customers to manage their savings and also their investment portfolio in one single account.

3.5.2 Globalization and Deregulations.

Deregulations of the banking sector removes much of the protection afforded to local banking institutions. In a liberalized environment, local banks have to compete with larger banks that are better capitalized. Larger banks have better access to global capital markets, better risk management practices, a larger product range and services and expertise to meet the requirements of customers. Local banks would need to improve in all these departments and a merged entity with a larger capital base provides a better opportunity to undertake the necessary improvements.

3.5.3 Technological Advances

Technological advances continue to affect the way banks do business. The introduction of ATMs, cash cards, 24 hour banking etc, is technology enabled. In addition, computing technologies have led to outsourcing of many non-core functions like payroll and benefits administrations, billing and invoicing. The benefits of these advances require large investments in IT infrastructure that can be offset by a large customer base attainable through mergers.

3.5.4 Customer Sophistication

Customers are also more discerning. They are willing to shop around for the best price-value relationship. Customers are also more willing to re-finance loans and other obligations. Customer loyalty is a fleeting concept. Banks are also responding to changing customer demands by providing services and products anywhere that customers shop, through branches, telephone, retail outlets, internet, estate agents, new home sites, supermarkets, etc. Thus, to be able to do all these competitively requires a whole new way of conducting banking.

These structural changes in the banking environment brought about by the growth of competition financial institutions, the advent of technology based changes, the increasing sophistication and needs of customers developments have forced banks to respond to enable them to maintain their profitability and loss of customer base.[xiii] Therefore, it is no surprise that BNM has opted to consolidate the banking sector in Malaysia through the merger of the banks that will see the banking sector coalesce around 10 anchor banking groups. The policy option is thus a reflection of the changed operating environment of the banking industry. The need for mergers can also be seen in the light of the state of the banks as a result of the crisis. Many of the banks were in such a weak financial state that their survival depended upon capital injection by Danamodal. Given the Malaysian authority reluctance to close banks, the merger as an option to strengthen the banking industry is of no surprise.

3.6 What is a Merger?[xlv]

A merger is a combination of two or more companies (in this case we refer to banks) into one company. The acquiring company (also referred to as the amalgamated company or the merged company) acquires the assets and liabilities of the target company (or amalgamating company). Typically, shareholders of the amalgamating company get shares of the amalgamated company in exchange for their existing shares in the target company or it could be part cash part share exchange. Merger may involve absorption or consolidation.

In absorption, one bank (or financial entity) acquires another bank. After merger, the target bank ceases to exist and the acquirer continues to exist. In consolidation, two or more banks combine to form a new bank. Despite the differences in terminology, the term merger is applied interchangeably in any of the above instances.

Mergers can be termed as horizontal mergers when firms in the same industry combine. The merger in the banking industry in Malaysia is largely a horizontal merger. Whereas a vertical merger is when firms in different but related industries combine. Vertical mergers generally take place in situations where firms have buyer-seller relationships.

3.7 Theories on Merger and Acquisitions

The reasons for mergers are many but are generally categorized into 5 major theories: -

3.7.1 Efficiency and Synergistic Rationale

This rationale is based on the idea that company A is more efficient than company B. And if company A takes over company B, efficiency will be increased to the level of company A and it will be beneficial to both the companies and also to society. Synergistic mergers translate into the ability of a business combination to be more profitable than the sum of the profits of the individual firms that were combined. Synergies may be realized through revenue enhancement or cost reduction. Cost reduction is gained through economies of scope and scale, replacement of inefficient management etc.

3.7.2 Growth

One of the main reasons for mergers is to enlarge the operations of the firm in new markets or new products. Firms can grow by making new investments and undertaking R&D and enter new markets. Firms can also expand by buying existing companies. Mergers and acquisition are faster routes to expansion in industries that are changing rapidly. In the context of the banking industry, except in the case of Maybank[1], the other anchor banks would definitely see the merger program as a growth opportunity. By merging, banks acquire a bigger branch network that allows a wider geographical coverage and increase customer base.

3.7.3 Information Theories

This theory suggests that the process of negotiations for mergers and negotiations release new information about the bidder as well as the acquiring firm. It signals to the market that the bidder has superior information about the target firm. Information on its value, a valuable patent, rich natural resources, customer base that is not fully exploited etc. may be revealed. Therefore, the merger and acquisition process reveals new information and helps to value the companies efficiently.

New information on both the anchor and non-anchor banks that is released and its role in price discovery is difficult to evaluate. Nevertheless, there has been reports that some of the merger negotiations have been stalled or slowed down due to dispute over the prices to be paid. Sellers may be holding the buyers to ransom to extract higher prices as anchor banks have a dateline to complete the merger, or it may be a genuine negotiation based on fair value. In any case pricing is subject to considerable uncertainly even in the best of times especially for unquoted banks.

[1] Given its size it can be a major player own its won. The approval of the Singapore Government to accord Malayan Banking full banking license to operate in Singapore, and its size makes it one

3.7.4 Agency Problems

Agency problems arise when managers have little or no ownership in the firms they manage. As a result, managers have less inclination to work for the benefit of the firm/owners and may be prone to consume benefits at the firm/shareholders expense and pursue investments and activities not necessarily in the interest of the firms/shareholders. This tendency is theorized, because, the shareholders bear the cost of such impropriety on the part of the managers. This problem is acute in countries where the shareholding is dispersed and dispersed shareholders do not have the incentive to monitor the managers. Many types of compensation packages are designed to ensure that managers and shareholders interest are aligned.[xv] Compensation packages that include share options and bonuses that are tied to profits, share prices are some of the ways managerial and shareholders interest is made to align. In addition, the market for managers is an important element in ensuring, that managers perform well. Non-performing managers can be easily replaced. This goes to show, the importance of developing human resource to ensure that industry does not suffer and has to tolerate inefficient management who cannot be replaced simply because there is no market for managers. In a liberalized environment managerial talent is sourced globally. [2]

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of the largest regional banks.

[2] Bank Negara restricts the recruitment of top bankers in local banks. Singapore and Hong Kong has a very liberal personnel policy for banking industry.

How then, mergers help to mitigate agency problems? The threat of a takeover and subsequent loss of employment may be enough to ensure firm is managed efficiently. Therefore, mergers are also used as a management-disciplining tool.[3]

3.7.5 Tax shields

Though it is rarely a sole reason for a merger deal, in many instances badly managed firms in a profitable industry would have accumulated losses. The tax credit to the acquiring firm can be quite substantive. However, mergers for tax reasons are subject to the prevailing tax laws.

Studies of mergers that took place in the early 1980s found improvements in both sales and profits of the combined firms following mergers.[xvi]In the case of mergers in the Italian banking industry, the operating cost in relation to total assets dropped to 2.4% between 1995-1997 compared to 3.0% in the 1980s. [xvii] A number of studies have looked into the effect of mergers on profitability in the banking sector but they report mixed results. Despite this inconclusive evidence, the fact that mergers in the financial sector continue to take place suggest that mergers does have a value and regulators in many parts of the world have or continue to encourage the merger of financial institutions. A more pertinent

[3] In Malaysia, shareholding of banks is concentrated. Many are held by family holdings and government agencies. The agency problem is less of a problem. In a highly concentrated form of ownership, and regulated banking industry, the role of mergers and acquisition to control agency problems is insignificant. The more serious problems would be the moral hazard problem as a result of implicit government guarantees and the capital structure of banks that is highly leveraged. Mergers do take place among banks but it is more as a way to save a failing banks rather than as a market discipline mechanism.

question in the local scenario is what would happen to domestic banks if they do not merge?

In Malaysia as in other East-Asian countries, shareholding is rather closely held and therefore, incidences of mergers and acquisitions are rather low. This is true In Malaysia as in other East-Asian countries, shareholding is rather closely held and therefore, incidences of mergers and acquisitions are rather low. for the banking industry too. In addition, since the banking industry is highly regulated, the bank license has a very high franchise value. In such an operating environment, it is not surprising that the consolidation in the banking industry was a Bank Negara initiative rather than market initiated.

The discussions trace the events of the Asian Crisis and the impact of the crisis on the banking sector in Malaysia. This was followed by an analysis of the government's responses to the crisis. Bank consolidation under 10 anchor banks is better appreciated in the light of the problems brought about by the crisis. Banks performance is closely tied to the macro-economic environment in which it operates, bank regulations and supervision, management expertise etc. On the other hand, mergers have the potential to address some of the operational shortcoming related to efficient operations, better risk management practices etc.

[i] Note: Philippines has managed to escape the "Asian Crisis" relatively unscathed. The report credits reforms undertaken in 1990-1996 and skillful crisis management during the turbulent period. In "Philippines-selected Issues. IMF Country Report 99/92/ August 1999.

[ii] Dornbusch,R., " Malaysia: Was it different," NBER Working Paper Series No. 8325 © by Rudi Dornbusch

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[iv] Ronald I Mckinon & Huw Pill, " International Overborrowing: A Decomposition of Credit and Currency", Working Paper Series, Economic Department, Stanford Unversity, Feb 1998, http://netec.mcc.ac.uk/WoPEc/data/Papers//wopstanec98004.html

[v] Roubini,Nouriel., "Basic Readings and References on the Causes of the Asian Crisis," http://www.stern.nyu.edu/globalmacro/

[vi] Roubini, Nouriel, et all , "What caused the Asian Currency and Financial Crisis: Part 1, A Macro economic overview", Sept 1998, http://www.stern.nyu.edu/globalmacro/

[vii] Krugman, P. ,"What happened to Asia? Massachusetts: MIT; DISINTER.html@web.Mit.edu

[viii] (Lin See-Yan, "Rebuilding ASEAN in the Wake of the Current Economic Crisis", Malaysian Journal of Economic Studies, Vol. XXXIV No. 1&2 June/December, 1997.

[ix] Bank Negara Annual Reports 1997, 1998

[x] Lin, See Yan, "Lest we Forget... What is right about Malaysia", The Star,31 December 1997

[xi] 8% Capital Ratio is the minimum requirement under the Basel Guild lines on prudent capital adequacy rations for financial institutions.

[xii] Report of the Group of Ten on the " Consolidation of the Financial Sector", January 2001. http://www.bis.org/publ/gten05.pdf

[xiii] Aswath Damodaran , "Corporate Finance-Theory and Practice", John Wiley &Sons, Inc 1997.

[xiv] Gaughan, Patrick,A., " Mergers, acquisitions, and corporate restructuring", 2nd Edition, 1999, John Wiley & Sons

[xv] Fama, E. "Agency Problems and the Theory of the Firm," Journal of Political Economy, April 1980,288-307

[xvi] Mark Grinblatt & Sheridian Titman, " Financial Markets and Corporate Strategy", Irwin/McGraw 1998.

[xvii] Speech by the Deputy Governor of the Bank of Italy, 12/11/1998- http://www.bis.org/review/r981126c.pdf