CHAPTER 4

THE BANK CONSOLIDATION EXERCISE IN MALAYSIA

4.1 INTRODUCTION

For its population, Malaysia is said to have too many banks. Up to 1959, there were 26 commercial banks consisting of 8 local and 18 foreign banks. When BNM was established in 1959, it encouraged the setting up of more local banks and the expansion of branch network into rural areas. This led to the rapid growth of the local banks. As at the end of year 1999, there were 34 commercial banks (of which 13 are fully foreign owned), 25 finance companies, 12 merchant banks and 7 discount houses. The local banking industry has historically been characterized by a large number of small institutions.

In Malaysia, the consolidation of financial institution through mergers was mooted by BNM in the 1980's in the wake of the economic and banking crisis then. Consolidation prior to this was left to market forces and it was found that the pace of merger was very slow as shown in Table 9.

Table 9 : Progress of Earlier Mergers

	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

In July 1999, BNM announced plans to reduce the number of domestic financial institutions to only six anchor institutions through mergers. (This was eventually increased to 10). There were 71 banking institutions with 2712 branches all over the country in 1999. Upon completion of the merger program, the number of domestic banking institution will be significantly reduced to 10 domestic banking group consisting of 10 commercial banks, 10 finance companies and 9 merchant banks[i]

With the mergers, the banks will have a larger asset base and achieve efficiency (through scale and scope economies) to withstand the onslaught of foreign competition when financial services liberalization eventually comes into effect eventually. Malaysia would also be following the trend of. banks in the United States, Germany, France and Japan where consolidation have taken place. Australia whose population figure is similar to Malaysia has only four major banks. Singapore is only looking at having two major banks in the country. Both Singapore and Australia have a liberalized financial services sector.

Hence, the objective of the merger program was to create a strong domestic group that will form the nucleus of the banking system. This is inline with the international trends in responding to a competitive banking environment in a liberalized environment. Domestic banks need to be more resilient, innovative and up to date. They will be exposed to greater risks such as market risks, credit risk, liquidity risk and operational risk.

4.2 Rationale for Bank Consolidation in Malaysia

A number of reasons have been cited for the need to expedite the financial sector consolidation process in Malaysia.

The small financial institutions are sometimes seen to be inefficient. Out of the 58 financial institutions in 1999, 35 were family owned[ii]. The smaller institutions sometimes offer higher interest rates and compete aggressively for deposits. They tend to price their loans higher to pay for higher deposit rates and get high-risk borrowers, as good borrowers prefer bigger and stronger institution with lower lending rates. When there is an economic recession, the smaller institutions suffer. Therefore, mergers remove smaller institutions from the market and allow them to participate in a much larger group. There was also a fear that the smaller family owned institutions would not be able to survive once foreign markets are opened up. However, historically bigger banks have not fared better then the smaller ones. During the recent crisis, both big and small banks were hit by NPL's. BBMB was the second largest bank in the country in terms of size but had to be rescued 3 times by the government. Ban Hin Lee Bank is a good example of a small but well-managed bank which was well-capitalized, low NPL's, offers a good range of products and has one of the biggest mutual fund business. Smaller banks also have a place in the economy especially if they are competitive and healthy. However BNM was of the opinion that Malaysian would have more confidence in their own larger than smaller banks. "Big is

better if the merged entity becomes more efficient," says Tan Sri Ramon Navaratnam "Bigger banks can take advantage of economies of scale and have more access to resources. At least in being bigger, they can spend more in research and development"[iii]. The important issue to note is that mergers provide a potential to improve efficiency. The actual realization of such potential has not been overwhelmingly borne out by studies on bank consolidation in other countries.

Greater efficiency to the banking system is envisaged under the merger exercise. Too many banks mean a fragmented and inefficient use of resources. Fewer banks will allow operation, branches and services to be streamlined. Banking services can be provided at lower costs due to savings on manpower, information system and reduction on branch network. It is envisaged that a merger exercise of this size will enhance supervision and reduce systematic risks besides providing larger and stronger institution capable of meeting future global competition. The merger plan will enable financial institution to reduce number of employees, close down unprofitable branches, upgrade their IT system improve operations and pass the benefits to customers. However, questions arise as to how the operations are synchronized, staff deployed, whether is size really important for efficiency and competence and implication on day-to-day management. Size may not always be linked to professionalism, efficiency and competence.

Impending liberalization and globalization hastened BNM's call for consolidation. BNM has to ensure stronger domestic banks when the financial sector is opened to foreign competition eventually in line with agreement under WTO. Despite the numerical dominance of domestic banking institutions, the 14 fully foreign owned banking institutions have been ahead of domestic banks in terms of financial performance as reflected in higher return in equity and return on asset, operational efficiency and product innovation in the domestic market.

The merger was also in line with government policy not to bail out weak companies but to rationalize business towards higher productivity. In the 1980's, the government had spent about RM2 billion to rescue deposit-taking cooperatives. Since mid-1998, the Government had spent RM60 billion taking bad loans of bankbooks and save ailing institutions. With the mergers and impending liberalization of banking services it is hoped to revitalize the entire banking sector by making it more competitive and efficient. Established banks might have become complacent due to the protected markets and the market niche they have acquired over the years.

A merger of banks with complementary business interests may result in consolidating their position in the market. In the banking industry in Malaysia, some banks have developed a strong base in industry and wholesale banking while others have a strong retail base. Merger of firms that operate in different markets allows the growth of the new merged entity in new geographical or

product markets. RHB group that is currently negotiating to merge with Bank Utama would be able to expand into Sarawak as Bank Utama, its merger partner has good branch network in Sarawak. .

The ultimate aim of the merger is for the creation of a domestic banking sector that is efficient, effective and competitive in a stable environment that can support and facilitate sustained and balance growth of the Malaysian economy. Even as the financial sector becomes increasingly diversified, the banking sector will continue to be an important source of financing for the domestic economy in the future. The banking sector plays an important role as financial intermediary and is a primary source of financing for the domestic economy, accounting for about 70% of the total assets of the financial system as at end 1999. As at end of the year 2000, the banking sector provided 83% of the total financing to the economy, with total credit provided by the banking sector accounted for 133.9% of our GDP[iv]. The strength of the domestic banking institution is an important element for financial stability that contributes to the long-term resilience of the economy. With a smaller number of larger banking groups, the banks will be able to compete fairly and improve on their competency, efficiency and quality of production.

4.3 The Anchor Banks

According to BNM's announcement in July 1999, the 55 existing financial institution will be merged into 6 core groups by April 2000. Each group would

ultimately comprise at least one commercial bank, a finance company and a merchant bank. The six core banks identified then were Maybank, Bumiputera Commerce Bank., Multi Purpose Bank, Public Bank, Affin Bank and Southern Bank. BNM also identified the so-called merger partners for the anchor banks. There were surprise and speculations as to how BNM decided on the choice of the initial 6 banks as the core banks and also their supposed partners. Some of the anchor banks identified by BNM were smaller than their merger partners. Table 10 shows the original list of anchor banks and their proposed partners.

Table 10 : Anchor banks and partners

Anchor Bank	Commercial Banks	Merchant Banks	Finance Companies
Maybank (78) Maybank Finance (22) Aseambankers M (4)	Pacific Bank (11) EON Bank (9) KBB (2)	Amanah Merchant Bank (2) MIMB (2) Sime Finance (2)	Eon Finance (5) Delta Finance (1)
Multi-Purpose Bank(8) Multi-Purpose Finance (2)	RHB/Sime Bank (54) PhileoAllied (10) Sabah Bank (3) Oriental Bank (9) Int. Bank Malaysia (1)	RHB Sakura (5) BBMB Merchant (2) MBf Finance (19) Bolton Finance (1)	Sabah Finance (<1) Oriental Finance (1)
Bumiputra Commerce (62)	Hong Leong Bank (14) CIMB (3)	Hong Leong Finance (8) CCM (5)	
Perwira Affin Bank (15) Affin Merchant Bank (4) Affin Finance (2)	Arab Malaysian Bank (28) Bank Utama (7) BSN Bank (7)	AMMB (14) Utama Merchant (1)	Arab Malaysian Fin. (19) BSN Finance (1) Asia Com. Fin. (3)
Public Bank (32) Public Finance (11)	Wah Tat Bank (1) Hock Hua Bank (5)	Sime Merchant (1) Adv. Finance (<1)	Inter Finance (<1)
Southern Bank (8) Southern Finance (1)	Ban Hin Lee (7)	Perdana Merchant (1)	Cempaka Finance (1) City Finance (1) UMF (6) Perdana Finance (<1)

Assets in brackets(RM billion)

Source: Industry as quoted in Malaysian Business, October 16,1999 in Merger by Decree by M.Shanmugam

Due to complaints from some bigger banks and financial analysts, in October 1999, BNM revised the number of anchor banks. Banks were also allowed to

choose their partners and anchors so long as the resulting merged entities have shareholders fund of at least RM2 billion and an asset base of at least RM25 billion. The final 10 anchor banks approved in February 2000 and its merger partners are as in Table 11.

Table 11 : Revised list of Anchor Bank and Partners

Anchor Bank	Banking Institutions in Group
Maybank	Malayan Banking Berhad, Mayban Finance Berhad, Aseambankers Malaysia Berhad, PhileoAllied Bank Berhad, The Pacific Bank Berhad, Sime Finance Berhad, Kewangan Bersatu Berhad
Bumiputra-Commerce Bank	Bumiputra-Commerce Bank Berhad, Bumiputra-Commerce Finance Berhad, Commerce International Merchant Bankers Berhad
RHB Bank	RHB Bank Berhad, RHB Sakura Merchant Bankers Berhad, Delta Finance Berhad, Interfinance Berhad
Public Bank	Public Bank Berhad, Public Finance Berhad, Hock Hua Bank Berhad, Advance Finance Berhad, Sime Merchant Bankers Berhad
Arab Malaysian Bank	Arab-Malaysian Bank Berhad,Arab-Malaysian Finance Berhad, Arab-Malaysian Merchant Bank Berhad, Bank Utama Malaysia Berhad, Utama Merchant Bankers Berhad
Hong Leong Bank	Hong Leong Bank Berhad, Hong Leong Finance Berhad, Wah Tat Bank Berhad, Credit Corporation Malaysia Berhad
Perwira Afin Bank	Pewira Affin Bank Berhad, Affin Finance Berhad, Perwira Affin Finance Berhad, BSN Commercial Bank Berhad, BSN Finance Berhad BSN Merchant Bank Berhad
Multi-Purpose Bank	Multi-Purpose Bank Berhad, International Bank Malaysia Berhad, Sabah Bank Berhad, MBf Finance Berhad, Bolton Finance Berhad, Sabah Finance Berhad, Bumiputra Merchant Bankers Berhad, Amanah Merchant Bank Berhad
Southern Bank	Southern Bank Berhad, Ban Hin Lee Bank Berhad Cempaka Finance Berhad, United Merchant Finance Berhad, Perdana Finance Berhad, Perdana Merchant Bankers Berhad
EON Bank	EON Bank Berhad, EON Finance Berhad ,Oriental Bank Berhad,City Finance Berhad, Perkasa Finance Berhad, Malaysian International Merchant Bankers Berhad

Source : Bank Negara Malaysia, Press Release, 14 February 2000

One of the pressing questions in the financial sector was the criterion used in determining the selected anchor banks. BNM had not come out with clear-cut rationale or criteria for the selection of the anchor banks. BNM stated that banks

that failed in the recent crisis were not considered. and priority was given to banks that were able to withstand the crisis. These would have effectively ruled out RHB and Arab Malaysian as these 2 banks sought aid from Danamodal in 1998 to overcome their inadequate capitalization problems. Smaller banks like Hong Leong, Ban Hin Lee and Phileo Allied, which came out of the crisis without major problems, were not considered.

There were also speculation especially in the foreign media that the government had weighted political ties in choosing some of the anchor banks. It was also felt that the Chinese owned banks were being sidelined.[v] Chapter 5 will attempt to explain some of the possible reasons why the banks were selected based on available documented data.

4.4 Progress of the Bank Merger Exercise

As of 31 December 2000, 50 of the 54 banking institution have been consolidated into 10 banking groups. Effectively, 94% of the total assets of the banking sector have been rationalized and consolidated.[vi]

Table 12 : Summary on progress of the merger program (as at 31 December 2000)

Anchor Banking Group	Awaiting regulatory approvals & vesting orders	Completed local mergers
• Maybank	PhileoAllied Bank (M)	The Pacific Bank
Mayban Finance	regulatory and vesting order	Sime Finance
Aseambankers		Kewangan Bersatu Bhd
• Bumiputra-Commerce Bank		Completed earlier
Bumiputra-Commerce Finance		
Commerce International Merchant Bankers		
• RHB Bank		Delta Finance
RHB Sakura Merchant Bankers		Interfinance
RHB Finance		
• Public Bank	Hock Hua Bank (vesting orders)	Advance Finance
Public Finance		Sime Merchant Bankers
• Arab-Malaysia Bank	MBf Finance (negotiating with Danamodal)	
Arab-Malaysia Finance		
Arab-Malaysia Merchant Bankers		
• Hong Leong Bank		Wah Tat Bank
Hong Leong Finance		Credit Corporation Malaysia
• Perwira Affin Bank	BSN Finance	BSN Commercial Bank
Affin Finance	BSN Merchant Bankers (vesting order)	
Perwira Affin Merchant Bankers		
• Multi Purpose Bank		International Bank Malaysia
		Sabah Bank
		Bolton Finance
		Sabah Finance
		Bumiputra Merchant Bankers
		Amanah Merchant Bankers
• Southern Bank		Ban Hin Lee Bank
		Cempaka Finance
		United Merchant Finance
		Perdana Finance
		Perdana Merchant Bankers.
• EON Bank	Utama Banking Group	Oriental Bank
EON Finance	(undergoing negotiations)	City Finance
		Perkasa Finance
		Malaysia International Merchant Bankers

Source: Bank Negara Malaysia

As of October 2001, most of the outstanding bank mergers have been successfully completed except the MBF merger with Arab Malaysia and Bank Utama with RHB Bank. Bank Utama's merger especially has been beset by many problems. The bank's initial proposal was to merge with the Arab Malaysian Banking Group but the deal failed. Subsequently, it tried to merge with EON Bank but these too failed. It is currently working out a merger with RHB Bank.

4.5 Issues in Bank Mergers

As in all mergers, a number of issues needs to be addressed in order to realize the benefits of the merger exercise.

4.5.1 The danger of good banks being brought down by merger with weak banks.

In any government-mandated merger, there is always a danger of a good bank being asked to take over a weak bank and in the process threatens the profitability of a profitable bank. Such instances have been observed in Japan under the main banking system and also in Taiwan. In Malaysia, such a fear is not without basis given that the authorities are reluctant to let a bank go under. Mergers may be used to save weak banks. In the case of the takeover of Bank Bumiputra by Commerce Assets Holdings Berhad (CAHB), analyst were skeptical of the how it would benefit CAHB given that within 9 months in 1998, Bank Bumiputra had lost 75% of its earning assets. However, if the executives were to adopt the culture of CAHB then it would be a good merger. [vii]

4.5.2 Operational Rationalization

The difficult period of a merger deal begins after the deal is signed. The hard decisions on rationalizations of branches and functions would invariably cause a lot of distress to the staff. Job security is a main source of worry. As part of the merger exercise, it was made very clear that there would be no layoffs. However, in reality there cannot be a merger exercise without some layoff due to

duplication. One area where fixed cost reduction can be achieved is through the removal of staff made redundant by the merger. Voluntary separation schemes are being implemented in many of the banking groups to remove redundant staff. BNM figures show banking sector employees declining from a little over 73000 in 1997 to about 64000 for the period until June 1999[viii]. The Federation of Trade Unions and Employees in Banks and Financial Institutions, an umbrella body for unions in the banking sector estimates that some 15000 employees will be made redundant following this round of mergers. Prior to mergers, banks like Southern Bank and RHB have successfully exercised VSS.

4.5.3 Size and Profitability

Size is considered as one of the major strengths in the finance industry. In fact the Financial Sector Master Plan specifically states that the bank merger program is to strengthen the banking industry to withstand the stiff foreign competition in the liberalized banking environment. This is also supported by studies that say banks (small and medium size banks) can gain much through economies of scale and scope. And the worldwide phenomenon of mergers and acquisition in the financial services industry provides evidence as to the importance of size in the banking industry. However the importance of size must be viewed with caution. In the 1980's, Japanese banks had top rankings in the world on asset size. However there are few of them in the world rankings now. If the merger turns out to be mere arithmetical number crunching of two balance sheets without a

proper strategic outlook and reorienting goals, it might result in disharmonious human resource problems and a clash of operating cultures that will threaten the profitability of the merged entity.

4.5.4 Regulatory Issues and Concentration of Risk.

Mergers create bigger and fewer financial institutions. From the regulatory and supervisory perspectives, it provides an illusion of fewer banks to supervise. However, the role of the Bank Negara in the post-merger environment is even more crucial. In the presence of few players in the industry increased vigilance on the part of the regulators is called for. The reduction of the number of banks and financial institutions leads to a concentration of risk. A failure of a large bank would cause more systemic risk than the failure of a smaller bank. This is because, in the post merger environment, these financial institutions have longer reach and they affect more households and businesses. Failure or loss of consumer confidence in any of the banks would cause a serious crisis and the role of Bank Negara as a lender of last resort would be severely stretched. The amount of emergency lending to restore liquidity or to guarantee deposits would be increasing manifold in a post-merger crisis. The cost of saving a failing bank would also be large and borne by the taxpayers. .

4.5.5 Cost Reduction

One of the major benefits of mergers is the potential to reduce much of the fixed cost in the form of personnel and infrastructure cost. Reducing fixed cost allows the banks to improve productivity ratios. In addition, utilizing economies of scale can reduce the cost of designing and delivering financial products and services. Investment cost and risk can be substantially reduced. While it is theoretically possible to gain these cost reductions, there is a limit to which profitability can be boosted with one off cost reductions. The success of a merger program aimed at enabling a competitive banking industry can only be sustained through productivity growth, growth through new markets and products/services from the banks. Therefore, the anchor banks would have a better operational efficiency vis-à-vis the banks that they merge with. However, overheads and operating costs are likely to be high in the initial period relative to income generated by the merged entities. Costs in the first years likely to be driven by expenses such as training program, investments to integrate the IT system, fees for consultancy and VSS for redundant staff.

4.5.6 Benefits of merged institutions and competition from foreign banks.

In the post merger environment, with increased competition from foreign-based financial intuitions, Malaysia is likely to see the creations of large financial supermarkets. These financial supermarkets in theory would be able to provide the full range of banking, insurance, brokerage services at competitively. Open and competitive financial markets would serve Malaysia by bringing global best practices in financial services, risk management, product variety and best practices in corporate governance.

The apprehension about the demise of local banks or that they will not be committed to the local economy preferring to serve multinationals may be unfounded. The experience of Australia whose banks are able to compete with the foreign banks and also in Hong Kong[ix] that is dominated by foreign banks without any impacts on its economic development are good examples. Nevertheless, bankers have often proven to have very short memory. Therefore, an ever-vigilant regulator with adequate expertise in bank monitoring and supervision is required to avoid a repeat of the excesses of the past. As such, the financial services industry in Malaysia would continue to be regulated albeit in a liberalized environment.

The chapter has traced the background to the bank merger exercise and its progress as of December 2000. In the discussions it is clear that while mergers has many benefits, there are operational issues that needs special attention. Having laid out the merger exercise in detail, Chapter 5 will analyze the anchor

banks based on their past performance and to identify some of the factors that could have been considered for the choice of the anchor banks.

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[i] Financial Sector Master Plan- Bank Negara Malaysia
[ii] Malaysian Business , 16th October, 1999
[iii] Malaysian Business, 16th February, 2000
[iv] Zeti Aziz, Governor Bank Negara, Opening Remarks at the Malaysian Banking Summit 2001 - "Scaling New Heights After the Banking Consolidation", 17th May, 2001
[v] Asian Wall Street Journal – Editorial dated 2 August 1999
[vi] BNM Press statement dated 31/12/2000
[vii] "Merging good banks with bad banks is still too risky", Meera Tharmaratnam. 26 May, 2000, AsiaFinance.com
[viii] Bank Negara Annual Report, 2000
[ix] David Carse, "The Banking Industry: Competition, Consolidation and Systemic Stability ; The Hong Kong Experience", http://www.bis.org/publ/bispap04f.pdf