BANK MERGERS HAVE FARED FAIRLY WELL

MIER SCOPE

by

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Merger and consolidation exercises taking place in Malaysia are just the beginning of a strategic transformation to enhance and upgrade the quality of the domestic financial sector to world class status, preparing them to embark on open competition in line with the World Trade Organisation's (WTO) agenda for services.

True, the large size of capital/asset is a very important enabler for a bank to emerge into an efficient, competitive and powerful bank. But the drive towards this end can only be achieved through changes in various operational factors, working and management systems, and an updated transaction system of the banking industry.

Bank mergers in Malaysia started relatively much later than the merger and acquisition waves in Europe in the1980s. Although there were earlier efforts by Bank Negara Malaysia to implement merger programmes for the Malaysian financial sector, it was not until after the economic crisis in 1997 that serious and effective steps toward this direction were taken that led to the completion of this whole merger exercise at the end of 2000.

Although it is theoretically clear that merger could broaden the product mix and reduce the cost of a merged institution, empirical evidence on the effect of merger on the economic of scale and operational synergies in the US and Europe has been rather mixed and unclear.

Thus, if the merger process is not sufficiently accompanied by a well-integrated marketing and administrative initiative, it will not lead to cost reduction and increased productivity. Thus, mergers should be led by banks that are able to manage the increased assets efficiently. But this does not necessarily mean that a bank with more assets has a high level of management efficiency and qualifies to lead a merger successfully.

After a year of merger and consolidation, the domestic banking industry has started to show a few signs of improvement. Indeed, it is very difficult and unfair

to expect the banking system to perform well on a platform of a fragile domestic as well as international economy, notwithstanding the sizeable increase in assets.

During the economic crisis in 1998, asset of the banking system declined by more than 14 per cent. The commercial banks were able to recover faster than the other banking institutions. It took just one year for the commercial banks to turn around the negative growth of their assets, registering positive growth in 1999. However, the percentages of asset growth after the economic crisis were much lower in comparison to the period before the crisis, particularly in 2001 where the size of the asset growth for the banking system was only 5.1 per cent.

Enhancing the liquidity condition is one immediate objective of the merger exercise. In general, there is strong liquidity in the Malaysian banking system. The highest liquidity position was 86.4 per cent recorded by finance companies in 1998. It is interesting to note that the economic crisis did not erode the liquidity position of the Malaysian banking sector which remained strong at 79.1 per cent in 1998. In fact, liquidity of the commercial banks rose to 80.3 per cent in 2000, upon completion of the merger and consolidation exercise. Except for the finance companies, overall liquidity of the banking institutions improved in 2000. However, a year after the merger in 2001, liquidity of the banking system declined slightly but remained strong at 78.6 per cent.

A right asset structure and high asset quality are important for the risk reduction and soundness of a banking institution. Although the economy experienced negative growth in 1998, successful recapitalisation of the banking industry had improved the asset quality . For instance, the asset quality, measured by the risk-weighted-capital-ratio (RWCR), of merchant banks was 15.2 per cent in 1998, followed by the commercial banks (11.7 per cent) and the finance companies (11.1 per cent). The RWCR for the banking industry as a whole was 11.8 per cent, up from 10.5 per cent a year ago in 1997. A year after the merger and consolidation exercise in 2000, the RWCR of all banking institutions rose, indicating better asset quality in the banking industry, with the commercial banks and finance companies registering higher RWCR of 12.8 and 12.1 per cent, respectively. Both represent a 0.6 percentage point increase year-on-year. The RWCR for the merchant banks rose by an even larger margin. With a RWCR of 19.6 per cent in 2001, it shows a 2.5 percentage point improvement from a year ago.

Another measure for assesing asset quality, the core capital for all banking institutions also improved a year after the merger and consolidation exercise in 2000. The core capital of the commercial banks increased to 11.0 per cent in 2001, up slightly from the previous year's 10.8 per cent. While the rise in core capital for the merchant banks was quite large (16.3 per cent in 2001 as against 14.6 per cent in 2000), that for the finance companies improved by a marginal one percentage point from 8.8 per cent in 2000. For the banking system as a whole, the RWCR rose to 11.1 per cent in 2001 which squares with our earlier observation that the merger and consolidation exercise helped to improve the asset quality in the banking system.

By contrast, efficiency, as measured by the ratio of pre-tax profit to average asset for the banking industry, declined slightly from 1.43 in 2000 to 1.09 in 2001 due to large loan loss provisions for that particular year. However, for the first quarter of 2002, profitability of the banking system increased to RM2.4 billion and pushing up the efficiency indicator to 1.1 per cent.

With a higher GDP growth of 3.9 per cent in the second quarter of 2002 and a 5.6 per cent in the third, there is a good likelihood that the pre-tax profit to the average asset of the banking industry for the current year will also be higher. If so, this will further reinforce the positive impact that the merger and consolidation exercise has on the efficiency of the banking system.

Estimation of the profit efficiency will be less meaningful without looking beyond the traditional balance sheet. The industry output will be seriously mismeasured by focusing only on the on-balance-sheet activities of banks and excluding the off-balance-sheet activities such as sales, servicing, securitisation, stand-by letter of credit, and derivative securities, which are expanding rapidly. The ratio of net interest income and non-interest income to the average asset of the banking institution is one of the indicators to measure the off-balance-sheet activities which will indicate the extent of the deviation of the banking institutions from their traditional activities.

The ratio of non-interest income to the average asset for the commercial banks rose by 0.2 percentage points from the previous year to 1.2 per cent in 2001. Dependency on the traditional-balance-sheet activities declined in 2001 and this is shown by the decline in the ratio of net-interest income to the average asset, from 2.6 per cent in 2000 to 2.4 per cent in 2001.

The ratio of net-interest income to average asset for the whole banking industry fell from 2.8 per cent in 2000 to 2.6 per cent in 2001, indicating less dependency on the traditional balance-sheet activities . A small rise in the ratio of non-interest income to average asset from 1.0 per cent in 2000 to 1.1 per cent in 2001 indicates that mergers and consolidations do have a small positive effect on moving the operation of banking institutions beyond their traditional balance-sheet activities.

Reducing the number of employees and branches and cutting the overheads are the usual outcomes of the merger process, so as to reduce costs. Unless these reductions are accompanied by a more than a proportionate rise in profits, it will not lead to improvements in terms of cost efficiency. In Malaysia's banking system, the ratio of cost to average asset declined from 6.5 per cent in 1999 to 5.3 per cent in 2000, suggesting an improvement in cost efficiency. Unfortunately, it deteriorated slightly to 5.5 per cent in 2001.

Although the domestic as well as the world economic environment for 2001 was cloudy, shrouding by poor investment climate and political uncertainties, the Malaysia's banking sector had performed reasonably well and manage to avoid severe deterioration of efficiency and escalating rise in the cost of operation.

Notwithstanding the importance of a large sized asset in enhancing the competitiveness of the banking industry, a highly-skilled manpower coupled with high-tech equipment and good post-merger strategies are vital for its efficient utilisation. This would include such considerations as prompt and customised services, customers' satisfaction, quality and price. The bottom line, therefore, in enhancing banking efficiency and profitability, is good relations with customers by satisfying their expectations, thereby winning their loyalty and trust.

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