A STUDY ON PRODUCTIVITY OF MALAYSIA'S BANKING SECTOR:
BEFORE AND AFTER MERGER

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This project is submitted in partial fulfillment of
the requirements for the degree of Bachelor of Economics and Business
with Honours
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ABSTRACT

A STUDY ON PRODUCTIVITY OF MALAYSIA’S BANKING SECTOR: BEFORE AND AFTER MERGER

By
Farhana binti Ismail

This study is undertaken to investigate the productivity of Malaysia’s banking sector within pre and post merger. In this context, the study attempts to evaluate technical efficiency, efficiency change, technical change and productivity of commercial banks, finance companies and merchant banks using a non-parametric Data Envelopment Analysis (DEA) and Malmquist Index approach. The results of this study show that on average, productivity across banking institutions increased at annual rate of 5.8% over the study period 1993 to 2004. Besides, the analysis results also indicated that almost all of the productivity growth comes from technical change (or innovations in banking technology) rather than improvement in efficiency change, which contributing for 6.1% of productivity growth, while the latter accounted for 0.2% decline. Furthermore, it is observed that the productivity of Malaysia’s banking sector has been improved (in terms of efficiency) after the implementation of merger program for domestic banking institutions in 1999. However, the productivity of banking institutions has been affected by certain economic conditions in year 2001 and 2004 (such as the September 11 tragedy and the process of capital rationalization that merged entities have undergone).
ABSTRAK

KAJIAN TENTANG PRODUKTIVITI SEKTOR PERBANKAN MALAYSIA:
SEBELUM DAN SELEPAS PENGGABUNGAN

Oleh
Farhana binti Ismail

Kajian ini telah dijalankan untuk mengkaji produktiviti sektor perbankan di
Malaysia (yang terdiri daripada bank perdagangan, syarikat kewangan dan bank
saudagar) sebelum dan selepas penggabungan dijalankan. Kajian ini juga bertujuan
untuk menaksir nilai kecekapan teknikal, perubahan kecekapan, perubahan teknikal dan
produktiviti sektor perbankan dengan menggunakan kaedah non-parametric Data
Envelopment Analysis (DEA) dan Indeks Malmquist. Keputusan kajian menunjukkan
produktiviti sektor perbankan meningkat pada kadar 5.8% setahun (secara purata) dari
tahun 1993 hingga 2004. Di samping itu, keputusan kajian mendapati hampir kesemua
pertumbuhan produktiviti berpuncu daripada perubahan teknikal (atau inovasi dalam
teknologi perbankan) berbanding peningkatan dalam perubahan kecekapan. Seterusnya,
kajian juga mendapati bahawa produktiviti sektor perbankan selepas program
penggabungan (yang bermula pada tahun 1999) adalah cekap. Walau bagaimanapun,
produktiviti sektor perbankan turut terjejas akibat daripada situasi ekonomi pada tahun
2001 dan 2004 (seperti tragedi 11 September dan proses penstrukturan modal yang telah
dialami oleh entiti yang menjalani penggabungan).
ACKNOWLEDGEMENT

The author wishes to express her sincere appreciation and thoughtful gratitude to several persons who have provided vital comments with valuable suggestion to the success of this study.

Special thanks to the author's supervisor for her invaluable inputs and information, constructive advises, clear guidance, steady support and helpful comments throughout the course of this study. Beside that, author also grateful to her supervisor in patiently explanation about Data Envelopment Analysis (DEA) software to complete her study.

The author also would like to thankfulness to the author's family members and friends for their valuable recommendations and continuous moral support for this period.

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CHAPTER ONE
INTRODUCTION

1.1 Background

Malaysia banking system consists of Bank Negara Malaysia, banking institutions (commercial banks, merchant banks and finance companies) and other financial institutions (discount houses, foreign banks representative offices, and offshore bank in the International Offshore Financial Centre in Labuan) (Bank Negara Malaysia (BNM), 2001).

As of the end of 1997, the licensed banking system consists of 35 commercial banks, of which 22 are domestic banks and 13 are foreign-controlled (or 43.6 percent of total financial system assets), 39 finance companies (13.6 percent), 12 merchant banks (4.0 percent), 7 discount houses (1.9 percent), and Bank Negara Malaysia (9.8 percent). On the other hand, non-bank financial intermediaries accounting for 27.1 percent of total assets of the financial system at the end of 1997.

In 1999, number of financial institution was 58 which comprised of 21 domestic commercial bank, 25 finance companies and 12 merchant banks. Obviously, Malaysia was over-banked, leading to inefficient use of resources and duplication of resources and infrastructure of domestic market. As a result of liberalization and globalization, Malaysian banking system has undergone a lot of structural changes. In addition, Malaysia was affected by the currency crisis and
financial crisis, started with descend of Thai Baht in July 1997, pushing a sharp impact of recession on Malaysia (BNM, 1999).

Due to globalization, the banking industry is expected to be more dynamic and competitive in their future operating environment. Thus, banking institutions are encouraged to increase their competitiveness in term of enhancing operational efficiency and become more innovative in developing competitively priced financial products. They also need to realize the need to serve the sophisticated needs of consumers and businesses nowadays. Before the financial turmoil, in late of 1997, Malaysian banking sector was stable and outstanding. However, finance companies have been over exposed to broad property and consumption credit. Besides, banks have also overextended themselves to politically well-connected corporate entities backed by volatile assets in the form of shares and real estate. The value of non-performing loans (NPLs) for the financial institutions also increased, with the increase for finance companies and merchant banks substantial compared to commercial banks (Soo Nam Oh, n.d.).

With response to the financial crisis, several policy measures were implemented to limit the amount of credit to the more volatile sectors of the economy, in order to reduce the high credit growth and to enhance financial disclosure by financial institutions. One of the policies that have been proposed by the government to promote economic recovery was the consolidation of banking system to resolve weaker bank institutions that had been badly affected during the financial crisis (refer to Figure 1 in page 6).
The merger program for domestic banking institutions was announced by Bank Negara Governor, Tan Sri Ali Abul Hassan Sulaiman on 29 July 1999. On 14 February 2000, Bank Negara Malaysia launched the consolidation program, where 58 institutions would be merged into ten anchors banking groups, comprising at least a commercial bank, a finance company and a merchant bank for each anchor bank group. In 2004, number of financial institution was 26 which comprised of 10 domestic commercial banks, 6 finance companies and 10 merchant banks. The 10 anchor banks are Maybank Bhd, Bumiputra-Commerce Bank Bhd, RHB Bank Bhd, Public Bank Bhd, Arab-Malaysian Bank Bhd, Hong Leong Bank Bhd, Perwira Affin Bank Bhd, Multi-Purpose Bank Bhd, Southern Bank Bhd and EON Bank Bhd (refer to Table 1 in page 4 and 5).
<table>
<thead>
<tr>
<th>Original Banking Group</th>
<th>Merged with</th>
<th>Entity after merging</th>
</tr>
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<tbody>
<tr>
<td><strong>1. Affin Bank Bhd</strong></td>
<td>BSN Commercial Bank Bhd</td>
<td>Affin Bank Berhad</td>
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<tr>
<td>Perwira Affin Bank Bhd</td>
<td>BSN Finance Bhd</td>
<td>Affin ACF Finance Berhad</td>
</tr>
<tr>
<td>Affin Finance Bhd</td>
<td>BSN Merchant Bank Bhd</td>
<td>Affin Merchant Bank Bhd</td>
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<td>Perwira Affin Merchant Bankers Bhd</td>
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<td><strong>2. Alliance Bank Bhd</strong></td>
<td>International Bank Malaysia Bhd</td>
<td>Alliance Bank Bhd</td>
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<td>Multi-Purpose Bank Bhd</td>
<td>Sabah Bank Berhad</td>
<td>Alliance Finance Bhd</td>
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<td>Bolton Finance Bhd</td>
<td>Alliance Merchant Bhd</td>
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<td>Sabah Finance Bhd</td>
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<td>Bumiputra Merchant Bankers Bhd</td>
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<td>Amanah Merchant Bank Bhd</td>
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<td><strong>3. Arab Malaysian Bank Bhd</strong></td>
<td>MBf Finance Bhd</td>
<td>Arab-Malaysian Bank Bhd</td>
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<td>Arab-Malaysian Bank Bhd</td>
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<td>Arab-Malaysian Finance Bhd</td>
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<td>Arab-Malaysian Finance Bhd</td>
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<td>Arab-Malaysian Merchant Bank Bhd</td>
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<td>Arab-Malaysian Merchant Bank Bhd</td>
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<td><strong>4. Bumiputra-Commerce Bank Bhd</strong></td>
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<td>Bumiputra-Commerce Bank Bhd</td>
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<td>Bumiputra-Commerce Finance Bhd</td>
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<td>Bumiputra-Commerce Finance Bhd</td>
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<td>Commerce International Merchant Bankers Bhd.</td>
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<td>Commerce International Merchant Bankers Bhd.</td>
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<tr>
<td><strong>5. EON Bank Bhd</strong></td>
<td>Oriental Bank Bhd, City Finance Bhd, Perkasa Finance Bhd, Malaysian International</td>
<td>EON Bank Bhd</td>
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<td>EON Bank Bhd</td>
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<td>EON Finance Bhd</td>
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<td>EON Finance Bhd</td>
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<td>Malaysian International Merchant Bankers Bhd.</td>
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<td>6.</td>
<td><strong>Hong Leong Bank Bhd</strong></td>
<td>Wah Tat Bank Bhd</td>
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<td>Hong Leong Bank Bhd</td>
<td>Credit Corporation</td>
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<td></td>
<td>Hong Leong Finance Bhd</td>
<td>Malaysia Bhd.</td>
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<td>7.</td>
<td><strong>Malayan Banking Bhd</strong></td>
<td>PhileoAllied Bank Bhd</td>
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<td>Malayan Banking Bhd</td>
<td>Pacific Bank Bhd</td>
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<td></td>
<td>Mayban Finance Bhd</td>
<td>Sime Finance Bhd</td>
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<td></td>
<td>Aseambankers Malaysia Bhd</td>
<td>Kewangan Bersatu Bhd.</td>
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<td>8.</td>
<td><strong>Public Bank Berhad</strong></td>
<td>Hock Hua Bank Bhd</td>
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<td></td>
<td>Public Bank Bhd</td>
<td>Advance Finance Bhd</td>
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<td>9.</td>
<td><strong>Utama Bank Bhd</strong> (now known as RHB Bank Bhd)</td>
<td>Delta Finance Bhd</td>
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<td></td>
<td>RHB Bank Bhd</td>
<td>Interfinance Bhd</td>
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<td></td>
<td>RHB Sakura Merchant Bankers Bhd</td>
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<td>10.</td>
<td><strong>Southern Bank Bhd</strong></td>
<td>Ban Hin Lee Bank Bhd</td>
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<td></td>
<td>Southern Bank Bhd</td>
<td>Cempaka Finance Bhd</td>
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<td>United Merchant Finance Bhd</td>
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<td></td>
<td></td>
<td>Perdana Finance Bhd</td>
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<td></td>
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<td>Perdana Merchant Bankers Bhd.</td>
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(Source: Bank Negara Malaysia Annual Report, 2001)
Figure 1: Objectives of the Banking Sector Restructuring Plan

Objectives of the Banking Sector Restructuring Plan

Short Term

- Halt the Vicious Cycle
- Stimulate Economic Recovery

- Encourage Banks to Lend

Long Term

- Create resilient banking system to withstand future shocks
- Develop efficient and competitive banking sector to support economic growth and contribute as sector of growth
- Provide foundation to broaden and deepen financial markets and strengthen financial infrastructure to meet future challenges

- Finance companies merger programme
- BNM to initiate mergers and use Danamodal to facilitate consolidation of the banking sector and to rationalise and revamp management where necessary
- Asset-backed securitisation
- Plan to chart the direction of the banking sector

Manage NPLs
Danaharta
CDRC
Rehabilitation Unit

Capital

- Danamodal

Funding

- Special Funds

(Source: Bank Negara Malaysia Annual Report, 1998)
1.2 Malaysia Banking System

Malaysia banking system consists of Bank Negara Malaysia, banking institutions and other financial institutions. Banking institutions consists of commercial banks, merchant banks and finance companies.

1.2.1 Bank Negara Malaysia

Bank Negara Malaysia (Central Bank of Malaysia) was established in January 1959, in line with the Banking Ordinance 1958 (revised to the Central Bank of Malaysia Act in 1994). Its main function is to supervise and regulate banking and related activities in Malaysia. Bank Negara Malaysia also helps to develop the institutions and infrastructure that are the foundations of a modern and solid financial system.

Objectives of Bank Negara Malaysia are;

i. to ensure monetary stability and a stable financial structure

ii. to function as the Government's banker and financial adviser

iii. to be the sole authority issuing currency in the country and to maintain appropriate currency reserves

iv. to affect the general credit situation so as to benefit the country's economy.
Over the years, the roles and responsibilities of Bank Negara Malaysia have evolved and expanded. Today, Bank Negara Malaysia focuses on the three pillars of central banking, namely monetary stability, financial stability and the payments system. In addition, the developmental role of Bank Negara Malaysia has been emphasized with respect to economic management, institutional building and the development of the financial system (Source: www.bnm.com.my).

1.2.2 Commercial Banks

A commercial bank is a type of financial intermediary and a type of bank. It raises funds by collecting deposits from businesses and consumers via checkable deposits, savings deposits, and time (or term) deposits. It makes loans to businesses and consumers. It also buys corporate bonds and government bonds. Its primary liabilities are deposits and primary assets are loans and bonds. The examples of commercial banks in Malaysia are Bumiputra-Commerce Bank Bhd, Public Bank Bhd and RHB Bank Bhd.

Commercial banks are the largest banking system in terms of total assets, total loans and total pre-tax profits. A commercial bank’s objective is to make a profit by intermediating between depositors (savers) and borrowers (investors), and this requires management of their different liquidity, maturity, and risk preferences.
The roles of commercial banks are;

i. Commercial banks must be able to evaluate a borrower’s creditworthiness and monitor performance.

ii. Commercial banks are fundamental to a developed economy, and are unintentional agents of monetary policy.

iii. Because of moral hazard and the risk of contagion, banks also exist in a much regulated environment.

iv. Banks must be able to forecast the effects of government policy on overall economic activity, interest rates, and risk in order to best manage their depositors’ money.

(Sources: Bank Negara Malaysia and www.wikipidea.org)

1.2.3 Finance Companies

Finance companies are the second largest financial institutions in Malaysia in term of deposits and total assets. The examples of finance companies in Malaysia are EON Finance Bhd, Hong Leong Finance Bhd and Arab-Malaysian Finance Bhd.

Finance companies businesses are defined as below;

i. To accept deposits on deposit account, saving account or similar account with it

ii. Loans

iii. Lease business or trade business; and
iv. Other business that arrange by Bank Negara Malaysia with the permission from Finance Minister.

1.2.4 Merchant Banks

Merchant banks begin to emerge in Malaysia banking system in 1970’s. Merchant banks involved in the short-term money market and capital raising activities including underwriting, loans syndication, corporate finance and management advisory services, arranging for the issue and listing of shares, as well as investment portfolio management.

Merchant banks are established specially to meet the needs of corporate sector. Thus, most of its operation depends on the consultant service and management offered to the corporate bodies, in addition with giving loans and receives deposits in whole. The examples of merchant banks in Malaysia are Alliance Merchant Bank Bhd and Arab-Malaysian Merchant Bank Bhd.
1.3 Problem Statement

Malaysian financial system can be structured into two broad groups namely the banking system and the non-bank financial intermediaries. Malaysia banking system consists of Bank Negara Malaysia, banking institutions (commercial banks, merchant banks and finance companies) and other financial intermediaries. On the other hand, non-bank financial intermediaries comprises of 5 groups of institutions, which are provident and pension funds, insurance companies, development finance companies, savings institutions and other non-bank financial intermediaries.

Initially, when Bank Negara Malaysia announced the consolidation of banks, the shareholders of banking institutions were not interested with the idea as they more focused in protecting their interest. These institutions were also badly hit by the 1985-1986 recession as they were burdened with high levels of non-performing loans (NPLs). In addition, they were also affected by the impact of over-lending to the property sector and exposure to share-based lending during the earlier boom years.

Due to the losses, Bank Negara Malaysia had come out with a rescue scheme to maintain integrity of public savings and the stability of the financial system. In this rescue scheme, Bank Negara Malaysia acquires shares in some of the ailing commercial banks, while the stronger finance companies absorbed the assets and liabilities of the inefficient finance companies. The number of finance companies was reduced from 47 to 40 as a result of the rescue scheme. The merger of one
commercial bank and the consolidation of the finance company industry were driven by the rescue scheme in order to restore stability in the banking sector. The implementation of the rescue scheme was a costly experience to the nation. There are 71 banking institutions in the country and 2,712 branches located all over the country. Obviously, Malaysia was over-banked and caused wasting of some resources due to duplication of branches in the same locality (BNM, 2001).

In July 1997, Malaysia was affected by the currency and financial crisis which was caused by the currency speculators. It began with the decreased of Thai Baht, and further on pushing a sharp impact of recession in Malaysia. Against this matter, a comprehensive restructuring plan was implemented during the second half of 1998. One of the policies that had been proposed by the government to promote economic recovery was the consolidation of banking system to resolve weaker bank institutions during the financial crisis.

The merger program for domestic banking institutions was announced by Bank Negara Governor, Tan Sri Ali Abul Hassan Sulaiman on 29 July 1999. He emphasized that merger exercise will not weaken the financial strength of the merged entities. Moreover, the creation of 10 anchor banks will ensure that the domestic banking institutions will be able to handle pressures and challenges arising from an increasingly competitive global environment and globalization. These supported the government's policy to rationalize businesses towards higher productivity. Business consolidation through merger is a common practice globally to achieve economies of scale and higher productivity. This is because banks must
merge to survive and faced of greater competition, especially in this era of globalization.

Moreover, World Trade Organization (WTO) had encouraged countries to open up their financial markets to allow entry of foreign banks. Malaysia cannot be excepted as all countries are now moving towards consolidating their banking system. In fact, Malaysia cannot be seen to fall backward in the consolidation of the banking industry. The process of getting the banks to merge in Malaysia started in mid-1980s as a result of economic recession. Table 2 shows the slow reduction in the number of banking institutions.

Table 2: The number of banking institutions

<table>
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<th>1980</th>
<th>1990</th>
<th>1997</th>
<th>1999</th>
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<tbody>
<tr>
<td>Commercial banks:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic</td>
<td>21</td>
<td>22</td>
<td>22</td>
<td>21</td>
</tr>
<tr>
<td>Foreign</td>
<td>17</td>
<td>16</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Finance Companies</td>
<td>47</td>
<td>45</td>
<td>39</td>
<td>25</td>
</tr>
<tr>
<td>Merchant banks</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>TOTAL</td>
<td>97</td>
<td>95</td>
<td>86</td>
<td>71</td>
</tr>
</tbody>
</table>

(Source: Bank Negara Malaysia, 1999)

In addition, IMF too has forced countries under their programmes (Indonesia, Thailand and South Korea) to reduce the number of banking institutions by effectively closed them down. However, Malaysia does not believe with IMF prescription to shut down the problem banks, as the social costs involved in terms of dislocation of resources are high. Thus, Malaysia came out with a more reasonable approach, guided merger, with the central bank playing a proactive role in solving the issues involved and the principle of fairness will be strictly applied to all parties in the merger. This is because, without the merger, the small non-Bumiputra financial institutions are likely to disappear as a result of globalization and increased
competition. As at 31 December, 2000, 50 out of 54 domestic banking institutions were consolidated into 10 banking groups (BNM, 2001).

With the government initiative to merge all banks into 10 anchor banks, it will be very interesting to investigate on the issue of productivity, effectiveness of the banking sector after the program being introduced. This study is to see whether the effectiveness of the banking sector increase or decrease after merger. However, it will focus on productivity of commercial banks, merchant banks and finance companies (1993-2004) as it are the main components of the banking sector.
1.4 Objectives

The general objective of this study is to investigate the productivity of Malaysia's banking sector within pre and post merger.

The specific objectives are;

i. to examine the productivity efficiency of commercial banks, merchant banks and finance companies in Malaysia before and after merger (1993-2004).

ii. to study the implications of merger on Malaysia's banking sector.

iii. to identify sources of productivity efficiency (efficiency changes or technical changes).
1.5 Rational of the Study

Merger can be defined as a transaction in which the assets of one or more firms are combined in a new firm. Bank Negara Malaysia (BNM) proposed merger programme for the domestic banking on July 29, 1999. One of the reasons for the bank merger was to promote economic recovery and resolve weaker bank institutions that had been badly affected during the financial crisis. Consequently, it also ensures that the domestic banking institutions will be able to handle pressures and challenges arising from an increasingly competitive global environment and globalization. These supported the government's policy to rationalize businesses towards higher productivity.

Generally, productivity of bank is important to generate the economy. Hence, the merger policy gives big impact towards the future of Malaysia’s banking sector. Thus, this study is carried out to analyze the bank merger effectiveness in Malaysia’s banking sector (as this merger had been implemented for almost five years). Besides, this study is attempt to investigate whether the productivity of banking sector increase or decrease after the bank merger (through efficiency score and changes in total assets, interest expenses, operation cost, number of branches, number of workers, etc). In addition, the purpose of this research is to investigate to what extent the restructuring of banking system affects the productivity of Malaysia’s banking sector in facing the global challenges.