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Does Operating Performance Really Improve Following Financial Institutions Merger: A Case of Malaysian Banks

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ABSTRACT

This study examines whether the recent bank mergers exercise in Malaysia create synergies reflected in corporate operating performance measures. Four accrual operating performance measures are used, i.e. Return on Asset (ROA), Return on Equity (ROE), Profit Margin (PM), and Earning Per Share (EPS). Using a sample of eight anchor banks for a sample period beginning 1997 through 2002, the results show that bank mergers lead to significant post-merger improvements, which is consistent with the findings of Neely and Rochester (1987) who also employ accrual performance measures in their study on savings and loan institutions in the US. The findings suggest that even though the mergers are 'forced' in nature, it is able to contribute to the synergistic benefits. The gain in the post-merger operating performance is likely to be due to the provisions for loan loss, which on average is much lower during the post-merger period compared to the pre-merger period. The study also finds that there is an insignificant continuance of pre-merger performance into the post-merger period.

Introduction

The number of bank mergers and acquisitions globally has, in over the past few years, increased dramatically. Because of the pace and its important to the people at large, the subject has been not only been widely discussed by academicians and market analysts but also ordinary citizens in the street. Furthermore, the issue is well documented and in literatures. According to Rhoades (1998), a total of 6,347 bank mergers occurred between 1980 and 1994 and this increasing trend will continue in the future. The rationale behind the increased mergers activities are been constantly analyzed by market analysts and academic researchers to identify whether merger exercises can achieve the stated objectives that have been decided earlier by the management. In particular, the reason for merger activities by any organization must be well spelt out clearly so that the shareholders, potential investors and customers are well informed.

As discussed in many literatures, one of the reasons for mergers and acquisitions and for creating diversified financial institution is the belief that only large and diversified banks can compete effectively and efficiently in the international bank and capital market environment. The other important reason for the merger is the international consolidation trend in financial service. Since the mid-to-late 1980s, many bank analysts as well as academic researchers have argued that bank mergers result in efficiency gains. On the other hand, some researchers have reservations on this finding. Furthermore, quite a number of empirical studies show no evidence of efficiency gain as such from the merger exercises. Even those few studies that have analysed the efficiency effect of horizontal mergers have found that such mergers do not, on average, yield efficiency gains.

Thus, one of the reasons that mergers and acquisitions are interesting phenomena to study is that, there is so little agreement in academia with respect to the reasons and results of mergers, yet corporate managers and bank managers continue to seek and complete mergers at an increasing rate. Empirical studies by many researchers have reported a disappointing operating performance results from mergers activities in many industries.¹

Problem Statement

In Malaysia, the issue of the consolidation of the banking sector emerged following the Asian currency and financial crisis during 1997- 1998. The crisis, which started with the devaluation of the Thai Bath, caused local currencies and stock market prices to decrease by about 60 percent of the market value and plunged many companies and financial institutions into deep trouble. In this environment of falling asset prices and crushing debt burdens, the banking and

financial institutions are no exception. They came under severe stress since they are more vulnerable compared to other non-banking institutions. The non-performing loans (NPL) accumulated by many local banks kept increasing and this led to a liquidity squeeze. Fortunately, these troubled banks were saved from a bankruptcy risk. Thanks to the swift action of the government in managing and restructuring the bad loans through the establishment of government agencies such as *Danamodal*² and *Danaharta*³. But this is just a short-term measure. The banking institutions will have to be on their own and must be self-sustainable in order to survive in the global market. As such, the merging of banking and financial industry is something that is inevitable in the long run.

Objectives of the Study

Therefore, the main objective of this study is to examine the operating performance of the Malaysian merging banks. In particular, the study will examine whether post-merger operating performances improved compared with pre-mergers following the consolidation exercise. Since prior studies on pre and post mergers and acquisitions operating performances focus more on large and developed markets such as UK and US, this study serves as a differentiated replication to test the generalisability of previous findings in the Malaysian context. Since the Malaysian market is relatively small compared to the UK, US and Australian markets, the results of this study could shed some light on its banking consolidation exercise. The second objective is to investigate whether the pre-merger performance will continue into the post-merger period for each of the four performance measures. The third objective is to explore whether banks listed on the KLSE, banks size and the bank mergers' smooth transition plays an importance role in determining the post-merger performance.

There is no published study to date that has investigated the operating performance of merging companies in Malaysia although there are substantial merger studies related to other merger activities such as market reaction to announcement and efficiency of merging companies. The present study contributes to the present literature in the following ways. First, it replicates prior studies elsewhere by providing Malaysian evidence on the impact of mergers on post-merger operating performance. Second, it properly compares the impact of 'force' merger on operating performance where post-merger performance is compared with pre-merger performance. Finally, it views the impact of mergers surrounding the Asian financial and currency crisis, in particular the survival of these banking institutions when some of their counterparts in Indonesia and Thailand collapsed.

The Process of the Consolidation of Banking Institutions in Malaysia

The Bank Negara Malaysia (Malaysian Central Bank) (BNM) has long advocated for the consolidation of the local banking institution since the early 1990s so that they become stronger and more efficient banking groups. The issue becomes more urgent with the increasing pace of globalization and financial liberalization and as such consolidation is inevitable for banks to be more competitive in the global market.

In early 1998, the BNM had given the banks a choice of selecting merging partners. All of the country's 54 financial institutions had to merge into 6 bigger and stronger groups to beef up the sector against future international competition. The six banks were given 'anchor' status, which meant they were leading banks that were grouped together with other banks and financial institutions. The six banks were Malayan Banking Bhd., Bumiputra-Commerce Bank Bhd., Public Bank Bhd., Perwira Affin Bank Bhd., Multi-Purpose Bank Bhd. and Southern Bank Bhd. Four months later, i.e. in March 2000, BNM yielded to pressure and accorded anchor status to another four banks. They were RHB Bank Bhd., Arab-Malaysian Bank Bhd., Hong Leong Bank Bhd. and EON Bank Bhd. All the anchor banks were required to complete the consolidation process by the end of December 2000.

There were many outstanding issues faced by the banks in the process of consolidation. Are shareholders happy with the 'force' consolidation? Will the mergers bring synergy? There may not be ready answers to all these but they need to be addressed. What more when the choice for anchors bank becomes another complicated issue. The identity and image of the bank are at stake. No one bank wants to give away their pride easily. Some argue that merger cannot be forced- it must be on a willing-buyer-willing-seller basis. In other words, the merger must be on the clearer basis, i.e. market-driven and not government-driven.

Literature Review

Mergers or acquisition can sometimes improve efficiency. This happened when the combined firms have shown improve operations performance through better financial and operational results. The concept, which is always, referred to as 'synergy' happens when two companies or more, combine together rather than be apart to be run more efficiently and effectively by lowering the cost as well as allocating scarce resources more appropriately. Moreover, by improving resource allocation these combined companies are expected to promote overall economics gains. As being discussed by Seth (1990), synergies can be created through many factors such as economics of scale and scope, and market power.

In examining the issues related to positive contributions from mergers, it is important to distinguish between cost reductions and efficiency improvements since they are not synonymous. Linder and Crane (1992) argued that reductions in expenses may be accompanied by corresponding reductions in assets and revenues, which may simply represent shrinkage of the firm rather than efficiency improvement. Similar argument is put forward by Rhoades (1998). He mentions that reductions in operation expenses may result from cutting employees, closing branches, consolidating headquarters offices, closing computer and back-office operations, and so forth. Such reduction in expenses as argued by the author will not automatically translate into improvements in efficiency as measured by an expense ratio, such as expenses to assets or revenues.

Study of scale and scope efficiencies in the United States using 1980s data generally suggest little or no cost efficiency improvement from the change in output (e.g Berger, Hanweck and Humprey 1987; Noulas, Ray and Miller 1990), although recent research suggests that cost scale economies may have increased in the 1990s (e.g., Berger and Mester 1997).

Data and Research Method

The sample consists of eight anchor banks that head their respective banking and other financial institutions merger groups approved by the Bank Negara Malaysia (BNM) after the fourth announcement, which was on 14 February, 2000 (A total of ten banking groups approved by the BNM). They are Malayan Banking Bhd, Multi-Purpose Bank Bhd., Arab Malaysian Bank Bhd, Public Bank Bhd, Arab Malaysian Bhd, Hong Leong Bank Bhd, Perwira Affin Bank Bhd, Muti-Purpose Bank Bhd, Southern Bhd and EON Bank Bhd. Two anchor banks are excluded from the analysis because of the unavailability of data for certain years. They are Bumiputra-Commerce Bank Bhd and RHB Bank Bhd.

The data are extracted from the financial statement of the sample banks obtained from the Kuala Lumpur Stock Exchange (BSKL), the head quarters and branches of the respective banks, and Bank Negara Malaysia (BNM). The data consists of up to three years prior (1997, 1998 and 1999) and two years after the merger year (2001 and 2002) for each sample banks. The year 2000 is excluded from the sample, as negotiation and a consolidation processes took place during that year.

Following Sharma (1996), earnings ratios are computed for each bank for three years prior and two year after the acquisition event. The accruals are selected on the basis of their relationship with the operating efficiency and their usefulness as discuss in previous studies. The financial ratios selected represent the operating efficiency and returns to shareholders. This is consistant with the purpose of the study of investing whether synergistic

gains could be created following corporate mergers as suggested by normative literature.

Accrual Performance Measures

The following are the formulas for the performance measures (ratios) used:

Accrual operating performance measures (ratios)

ROA = Net Income before tax / total Assets

ROE = Net income before tax / total equity (shareholders' funds)

PM = Net income before tax / interest income

EPS = Net income after tax / number of shares outstanding

The following are the definition of critical items:

Net income before tax (NIBT) is interest income less interest expense plus non-interest income less overheads less loan and finance loss and provisions.

Sales is the total interest income recognised (accrued) for the year.

Net income before tax (NIBT) is extracted directly from the Income Statement.

Cross Sectional Regression Analysis

Following Healy, et al. (1992), the study test whether the pre-merger performance period continues into post-merger performance period, the study investigates through a cross-sectional regression for each of the eight performance measures:

$$Y_{ai} = \alpha + \beta X_{ai} + \mu_{ai}$$

where Y_{ai} is the mean (median) post-merger performance for company i and X_{ai} is the pre-merger performance for the same company. The α represents each of the four operating performance measures discuss earlier while β represents the association between the pre-merger and post-merger performance. A significant β will suggest continuance of pre-merger performance into the post-merger period. Consequently, α which is independent of the pre-merger performance would indicate the extent to which post-merger performance is a function of the merger.

Empirical Results

The performance of each sample banks are analysed and the study finds that each of the bank experiences an improvement in performance in all the performance measures used, except for Affin Bank Bhd, which experienced a tremendous decline in the NIBT in the year immediately after the merger and

therefore gravely affected overall performance measures for the year for the bank as well as and the mean for all sample banks post-merger years.

The study scrutinizes the income statements and discovered that for the year 2001, Affin Bank Bhd. had made a provision for loan loss amounting to RM826 million. This figure is far above the average provision for other years of study, which amounts to only RM204 million. We then looked at other banks with the same anomaly and discovered that Arab Malaysian Bank Berhad experiences the same anomaly but in different year, that is 1999 (year -1, pre-merger). The bank provided the sum of RM661.5 million for that year compared to an average of RM124 million per year in the other 4 years.

The provision for loan loss for a particular year is not necessarily for the loans granted during the year, but in most cases they are related to the loans granted in the previous years. Therefore, we argue that the performance measures for that particular years (Arab Malaysian Bank Berhad for 1999 and Affin Bank Berhad for 2001) are biased and therefore do not reflect the true performance of the banks, pre as well as post-merger years. Therefore, the study will exclude these banks from further analyses.

At this point, the study does not intend to elaborate on those figures. We know that the lower the provision for loan loss, the higher is the income before interest and tax. This further translates into higher ROA. However, the provision for loan loss for any one-year is not an indicative of inefficiency of management in that particular year. A further and in-depth look at a particular bank's policy and national policy on Non-Performing Loan is vital and necessary before any conclusion can be reached.

With regard to the cross-sectional regression analysis, the results show an insignificant continuance of pre-merger performance into the post-merger period except for the ROE. The betas for ROA, PM and EPS are statistically insignificant at usual 5% level. Thus, mergers are relatively weak and have an insignificant positive effect on the post-merger performance. The results suggest that the banks pre-merger and post-merger periods in Malaysia are independent.

Sensitivity Tests

The sensitivity tests investigate the potential effect for (1) banks listed in the Kuala Lumpur Stock Exchange (KLSE) (2) the size of the banks and (3) the smooth transition banks merger on post-merger performance. Our results show that the accrual of bank listed in KLSE post-merger performance improves drastically for all ratios compared with the accrual of all the sample banks. The results of the present study also suggest that banks capital exceeding 2 billions show great improvement than the combinations of all sample banks in the post-merger period for all mean measures with an exception for EPS. Finally, we find that banks that experienced smooth transition did perform better after the merger than that of the overall sample banks for all performance measures except for EPS.

In addressing the synergy issue, it appears from the evidence that banks consolidation exercises in Malaysia, in general, do generate synergies proxies by operating performance measures. Even though the merger processes are not market-driven but forced in nature, the findings are quite remarkable in that it shows a significant improvement in the post-merger operating performance.

Concluding Remarks

This study sought to examine two basic questions related to the performance of merging firms, i.e. anchor banks. First, does the operating performance of anchor banks really improve following the consolidation exercise? The results from the present study indicate that the post-merger operating performance of anchor banks, on average, does improve compared to the pre-merger operating performance, which contradict results from previous research (Healy, et al., 1992) and (Sharma and Ho, 2002). The reasons for the differences in the findings are many. They include the methodology employed and the types of industries used as a sample in the study. The findings of the present study suggest that even though the mergers are 'forced' in nature or government-driven, it is able to contribute to the synergistic benefits. From our analysis, the gain in the post-merger operating performance is due to the provisions for loan loss, which on average is much lower during the post-merger period compared to the pre-merger period.

Secondly, the present study analyses whether there is a continuance of the pre-merger performance into the post-merger period for performance measures, as suggested by Sharma and Ho (2002). We find that pre-merger operating performance does not continue into the post-merger. The results suggest that the banks pre-merger and post-merger periods in Malaysia are independent.

The results and implications should be considered in light of the following limitations. First, it must be noted that the findings of the present study have a generalisability problem since only financial institutions and banks are examined. Second, the periods of study are quite short to have a sufficient in depth analysis and to allow sufficient gestation of the combined banks to generate operating performance post-merger gains. Third, the present study does not use industry performance indicators or a matched control firm as benchmarks because of the unavailability of the data. Barber and Lyon (1996) mention the need of using matched control firms as benchmarks in evaluating operating performance. A fourth limitation relates to the potential effect on the loss provision. An in-depth analysis on the bank's policy and national policy on Non-Performing Loan is vital and necessary before any conclusion can be reached.

Further research should be directed towards addressing the above limitations and the limitations of prior studies. Another area of potential research is related to the method of payment used in mergers and acquisitions, as suggested by various studies (see Myers and Majluf, 1984 and Fisherman, 1989).

Endnotes

- ¹ See Rhodes (1998) for review of literature.
- ² The agencies established to raise funds for the recapitalisation and strengthening of banking industry.
- ³ The agencies objectives are to remove non-performing loan (NPL) distractions and maximize recovery value of acquired assets.

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