An empirical study of international correspondent banking in Australia

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CHAPTER ONE: INTRODUCTION

This research is concerned with international correspondent banking (corbanking) and the management of this activity by banks in Australia. The research involved literature and industrial reviews, a case study and an empirical survey. The thesis examines the factors contributing to the establishment of international correspondent banking relationships and criteria of selection of key correspondents within an Australian context by statistical, regression and factor analysis. Due to scarcity of theoretical literature on international correspondent banking in an Australian context, the forming of the research constructs will be mainly based on United States literature, original work on a case study and an international correspondent banking industrial survey in Australian. The purpose of this introductory chapter is to demonstrate the significance of the study areas in section 1.1, establish the boundaries or scope of the study in section 1.2, clarify the overall objectives of the thesis in section 1.3 and finally lay out the organisation of the thesis in section 1.4.

1.1 THE SIGNIFICANCE OF THE AREAS OF STUDY

Individual banks cannot cover all geographical locations in the globe by setting up branches, subsidiaries or joint ventures for reasons such as insufficient business volume, large capital investment or the non-availability of banking licenses. Therefore, many banks in Australia cover their global business by an international branch and/or subsidiary network or other forms of organisation with equity commitment, and supplemented by its international corbanking network. Corbanking business is a neglected area of international banking services among banks in Australia. This gives the research area significance in terms of theoretical contribution on the one hand and applied research contribution on the other. This research will look at international corbanking from a
macro-view, that is the determinants for banks in Australia to go for corbanking relationships and from a micro-view, that is the selection criteria of international correspondents.

International correspondent banking relationships are traditionally outgrowths of circumstances that have existed for a long time, such as necessity for payment/settlement and trade finance. Previous methods for doing corbanking businesses were based on maintaining compensating balances and reciprocity but the tough competitive banking environment made corbanking business unprofitable using traditional method. Changes in the Australian banking scene that affected this include:

(i) Low asset growth in recent years: Between 1986 and 1989, the banks' domestic asset base increased at an average annual rate of approximately 23%. Since 1991, the rate of growth has fallen to an average annual rate of approximately 5%, primarily as a result of (a) the collapse of asset prices in the late 1980s; (b) increasing competition from non-bank financial institutions, including mortgage originators; and (c) the impact of corporations dealing direct with the market and not through the banking system, known as disintermediation. The lack of growth opportunities in the Australian market has led some of the major banks to diversify their asset base and expand offshore operations and investments or a mix of offshore and onshore operations including merger and acquisition for growth and competitiveness;

(ii) Aggressive pricing policies: Aggressive competition in a market exhibiting low growth has led to increasing pressure on pricing such as the residential mortgage market;

(iii) Restructuring of service delivery channels: These involve rationalisation of branch networks and the centralization of many services that had previously been undertaken at the branch level, with expansion of electronic, internet, home and telephone banking
capabilities and reduction in high cost "over-the-counter" transactions. All these involve continuing investment in technology that is essential to the development of the banking industry and also create a certain degree of over-capacity in particular, bigger local banks;

(iv) Changes of Saving Pattern: Depositors have become investors who switch deposits with banks to obtain a higher return. These put pressure on the interest margins of the banks;

(v) Focus on Non-Interest Income: The submissions to the government Wallis Inquiry in March 1997 by the banks and other financial institutions highlighted the fact that less than 15% of the costs involved in providing retail transaction accounts were recovered from direct fees and charges. Recovery of the remainder of the costs has traditionally been through interest rates and cross-subsidisation from other services. Therefore, banks need to look for new areas to have non-interest income such as funds management, payments, documentary credit and collection, capital markets trading and structured finance transactions which involve correspondent banking services;

(v) Excessive Capital: The major banks are currently operating with capital in excess of both immediate needs and the regulatory minimum of 8% capital adequacy ratio. Excess capital tends to reduce returns on equity and puts pressure on management to grow business, either internally or by acquisition, or to return capital to shareholders;

(vi) International Integration of Financial Services: Banks in Australia like the National Australia Bank would want to be a globally integrated financial services retailer and thus needs to be an integrated distributor of financial services and banking products (Australian Financial Review, 21 Nov 1997, pp33). Globalization and hence international integration is the way for strong competitiveness, growth and profitability in the Australian banking industry;
These factors force the banking industry to look for alternatives for their business expansion or penetration for survival purposes, one of which is the modern international correspondent banking which is a cheap way for banks in Australia with more stable fee-based income to go offshore compared with branches and subsidiaries. Recently corbanking services have also moved to fee-based services as well as some interest-bearing income business. Fee-based business can basically have a steady revenue for banks with little risk compared with interest based income. International Corbanking services have even become a strategic and a core business for banks like Standard Chartered, Bank of America and Chase for globalization.

1.2 SCOPE

Contemporary correspondent banking is getting more complex. The scope of this research is to look at the international correspondent banking business at all licensed banks under Reserve Bank of Australia as at 31 October 1996 but further regrouped to forty three (43) banking groups in Australia and classified as ten (10) bank groups, and in particular focus on the determinants for the establishment of international corbanking relationships, how the respondents choose their correspondents overseas, corbanking activities and practices and management. “The triangulation method”, a multiple-method (Hoque and Hopper, 1997) via the case study of the Commonwealth Bank of Australia (CBA), an empirical survey of international corbanking in Australia and the modelling of determinants and criteria will then be used to observe the Australian international correspondent banking industry from different perspectives.
1.3 OBJECTIVES

The objectives of this thesis are to:

(i) Outline the development of international correspondent banking practices, operations and management in Australia, the Australian banking systems and payment systems, and compare and contrast the modern and traditional views of international corbanking;

(ii) Review the existing theoretical and empirical literature in the area of international correspondent banking with emphasis in relation to determinant factors for entering international corbanking businesses and criteria for selection of correspondents overseas.

(iii) Summarise research methodologies, method assumptions, strength and limitations of methods to be applied;

(iv) Develop a core research consisting of three components as follows:

   (a) An international corbanking case study of CBA;

   (b) An empirical survey of international corbanking of all banks in Australia;

   (c) Detailed analysis and model testing of two chosen areas - determinant factors of international corbanking and selection criteria of international corbanks - starting from (a) and (b) which are applicable to decision processes in building international corbanking network for banks in Australia.

(v) Discuss implications of the findings from (iv) (a), (b) and (c) of the core research, research limitation and future corbanking and research directions.
1.4 ORGANISATION OF THE THESIS

The arrangement of the thesis will be an introduction chapter-chapter one; four background chapters (International Corbanking and Its Development-chapter two, Overview of the Australian Banking System and Payment System-chapter three, Literature-chapter four and Research Methodology-chapter five); three component chapters of the core research (Case Study on Corbanking in CBA-chapter six, International corbanking surveys in Australia-chapter seven and Models of International Corbanking: Determinant Factors of International Corbanking and Selection Criteria of Corbanks-chapter eight); and a summary and conclusions chapter-chapter nine.

Chapter Two: will outline international correspondent banking and its developments in the Australian context which virtually provides the background to the development of the international correspondent banking industry as an alternative for providing cross border financial services and thus identifies characteristics of traditional and contemporary international correspondent banking;

Chapter Three: will describe the Australian banking system including classification of banks for research data grouping and non-banks providing banking services. This chapter will also describe the Australian and international payment systems involving low and high value transactions systems;

Chapter Four: will then review the literature in the areas of international correspondent banking systems by first identifying general themes in international correspondent banking. International banking and general banking theories will then be assessed which specifically dealt with factors that influence the choice of international corbanking relationships and selection criteria for international correspondents. This chapter also provides a theoretical framework for the research in the Chapter six, seven and eight;
Chapter One

Chapter Five: will describe the research methodology and design including the triangulation method as the theoretical basis for a major case study, the empirical survey and the modelling;

Chapter Six: will present and analyze the results of the case study of CBA;

Chapter Seven: will present the findings of international corbanking industrial survey in Australia;

Chapter Eight: will develop regression models by testing hypotheses based on knowledge and background obtained from Chapters two to seven as well as findings from Chapter six and seven. More specifically, this chapter will test those hypotheses for modelling determinant factors of international corbanking relationships and selection criteria of international correspondents in an Australian context;

Chapter Nine: will conclude the findings and modelling, the implications of the findings, the limitations of the research and future research directions.