An empirical study of international correspondent banking in Australia

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CHAPTER TWO: INTERNATIONAL CORRESPONDENT BANKING AND ITS DEVELOPMENTS

INTRODUCTION

This chapter is the first of the four background chapters where other chapters are chapter three - Australian banking systems, chapter four - literature review and chapter five - research methodology for the research results in chapters six, seven and eight. Correspondent banks may also be called banker banks. Unlike more obvious front-line services such as corporate banking and consumer banking, correspondent banking has always been viewed as a backroom operation. By maintaining a global network of interbank relationships, the correspondent banking department provides the necessary support to other departments within its own banking group and other banks. It can act as a cross-seller of products of other business units within the bank. With the world integrating into a single universal market, correspondent banking will play an increasingly important role in facilitating the execution of international financial transactions. When banks want to expand cross-border businesses, in particular for transaction services. The effective and cheaper way is to use correspondent banking relationships, a contractual mode for provision of financial services. International banking via subsidiaries, branches or joint ventures require capital investment and hence the risk of losing capital. By contrast corbanking involves no capital investment and hence is low risk. Corbanking performs five basic functions - liquidity smoothing, global liquidity distribution, international distribution of capital, hedging of risk and regulatory avoidance which constitute a enormous potential in international banking. Many banks consider
international corbanking as a strategy to expand their international banking in the form of strategic correspondents or alliances and thus to achieve targeted profits and share prices. Dynamic banking industry powered by competitiveness, globalization, technology in particular e-banking/internet banking, deregulation, de-intermediation, movement of international capital funds after Asian financial crisis and popular strategic alliances have strong impact on corbanking.

The sequence of this chapter is as follows: the definition of international correspondent banking will be in section 2.1, the development of international corbanking will then be discussed in section 2.2. Corbanking services and products will be considered in section 2.3, traditional and contemporary characteristics of international corbanking are also compared and contrasted in section 2.4, this chapter is completed with a conclusion in section 2.5.

### 2.1 DEFINING CORBANKING

Correspondent banking has no precise definition. The definition of corbanking varies from bank to bank due to the nature of banking business and policies. However, generally, correspondent banking involves banks providing services to their own customers through the use of another bank as an agent. Correspondent banking deals with a whole spectrum of bank-to-bank relationships. It can take different perspectives, ranging from domestic transactions to global agency agreements (Palmer, 1990). Corbanking does not encompass all types of bank-to-bank business, which is usually distinguished by a continuous business relationship with a deciding factor in determining whether or not two banks have an account relationship. Nevertheless, this distinction is not always an obvious one and there are many clashes within any bank over which departments should
be handling specific interbank transactions (Wilkins, 1993). Day-to-day international banking relies on the network of correspond banking relationships. Correspondent relationships are a contractual mode for the provision of a range of services in international finance which is certain circumstances and can be superior to internationalization or multinational banking.

For most banks, correspond banking is primarily an international rather than national activity (Shapiro, 1992). Direct fees are nowadays commonly used to pay for services, but implicit payments in the form of correspondent balances have been widely used in the past. It is also possible to use both direct fees and correspondent balances as a form of payment. Comparing the difference between a branch and a correspondent, Webster (1981) states that “the substantial difference between the branch and the correspondent is that while the former is managed by the servants of the banker acting under his supervision and control, the latter is independent in business and acts only on occasion as an agent at his discretion. The fact that the correspondent is a legal entity independent of the banker who employs him does not, however, mean that there exists any contractual relationship between him and the banker’s customers on whose business he is being employed…. As between the customer and his banker... the latter is liable for the acts of his correspondent in exactly the same way within the same limits as for those of his managers and servants, for it is immaterial to the customer whether the banker operates through a branch or through a correspondent, unless, of course, the banker expressly stipulates that he is not to be so liable” (Yeow, 1989, Page 1).

Banks are multi-product firms. They provide a range of services that can be described as transaction services that include settling debts for their customers, and an intermediation service that links seekers of capital with suppliers of capital by transforming the
characteristics such as size, maturity, liquidity and risk desired by the former into ones acceptable to the latter. Some types of transaction services such as international trade payments lead banks to use agents-correspondents, while banks wishing to offer intermediation services across borders in particular credit related services would be more likely to establish a multinational branch. Banks supply (use) corbanking services known as correspondent (respondent) banks or correspondents (respondents). A correspondent and a respondent maintain a relationship in various ways such as exchange corbanking contracts or they open (\textit{Nostro} and \textit{Vostro}) accounts with one another. Furthermore, because of the nature of modern banking it is almost impossible for users not to provide or for providers not to use corbanking services. Corbanking services can be isolated from other banking services only with difficulty since corbanking is used to support other banking services within the same bank or external to other banks. Therefore, it is necessary to look at four perspectives: the bank as a user, a provider, risk, and relationships management, in order to have an insight into corbanking businesses of a bank.

2.1.1 Corbanking Providers and Users

Corbanking is a subsystem within the banking system. The banks could be classified as provider-correspondent banks and/or user-respondent banks of corbanking services. Many large, international banks operate in foreign markets through a combination of their own branches and correspondent banks. The reasons are that the corbanks usually are larger domestic banks with good networks, which are more efficient with charges lower than the costs incurred by the branches if the services were to be performed by themselves. Most banks are providers as well as users. If banks provide more services
than they use, they may be considered as providers. For instance the ANZ is a large provider of corbanking services in Australia but it may be a user in Singapore. The Standard Chartered Bank, Sydney is a provider of corbanking services worldwide since it has a very large international network but it also needs corbanking services in Sydney or other countries. The Bank of China, Sydney is a user since it does not have very extensive international network, however, it does provide limited corbanking services such as trade finance corbanking services for the China Market (Chan and Naughton, 1995 and 1996).

2.2 DEVELOPMENT OF CORBANKING IN AUSTRALIA

Correspondent banking has undergone dramatic changes in the past few decades. These changes have impacted on the products and services that are offered, the methods of pricing the products and services and the methods used in promoting them. Australian banks have offered international financial services to their customers through agency arrangements from early in the last century. Initially, the small numbers of agents were concentrated in Britain, reflecting the very close trade and capital flows between the two countries. However, the numbers of correspondents grew steadily as foreign banks sought an Australian agent to allow their customers to make or receive payments, and vice versa. Then the number of correspondent relationships rose steadily covering the United Kingdom, Europe, America, and Africa. Between the two world wars, all of Australia’s trading or commercial banks could offer their customers a payments and collection service in any of the principal ports or commercial centres in the world. The widening of sources of commerce coupled with the rapid growth of overseas banks and their branches led to the expanding of lists of agents and correspondents so that by the early 1960s, the
English, Scottish & Australian bank (ES&A), one of Australia's smaller banks, had accounts with nearly one thousand correspondents, excluding multiple branches in the same country, and in 134 countries (Agency Arrangement List 1964-1970). No Australian bank established a branch elsewhere in the world before the 1970s and this implied multinational banking was eschewed by Australian bankers.

The focus of this overseas business was retail deposit gathering and lending with international financial services and foreign exchange dealing as a profitable sideline. Therefore, Australian banks needed to use correspondent banking relationships to provide cross border financial services. Corbanking arrangements during the period of corbanking developments include the following:

(i) Contracts and Costs. Economic activity involving transactions, whether in the market, or within the firm, or through some intermediate arrangement such as an agency of corbanking, takes place through a series of formal or informal contracts. Theories such as transaction-cost economies and principal-agent theory (Williamson 1979 and Holmstrom & Tirole 1989) may explain why the correspondent arrangement was the organizational mode of international banking preferred by some Australian banks. However, the transaction-cost theory does not predict that internalization will necessarily reduce transaction costs. To know when it might do so requires very careful specification of the nature of the transaction, its frequency and complexity, together with a consideration of the degree of difficulty in contracting. The Principal-agent theory highlights the problems that arise in negotiating and writing complete contracts that are unambiguous, cover every contingency, measure the performance of each party and are enforceable. Because of unpredictable fluctuations in interest and foreign exchange rates, commodity prices and defaults by customers and other banks, banks open themselves to
moral hazard and opportunistic behaviour. Costs of agency of correspondents were increased in two ways. First, banks had little discretion over the choice of agents but they were driven by the needs of customers, such as would be the case of a bank in a town with limited banking facilities. Second, the total costs of operating the correspondent network increased directly with the growth in the list of correspondents and the volume of transactions with them which was not just in the period shortly after World War Two but also in the early 1990s for some banks in Australia. In addition to the need to establish corbanking networks, most of the funds transfers, while being of considerable size in aggregate, tended to take place infrequently in specific geographic locations, small scale and intermittent business thus offered little incentive to open a branch. A further reason why banks were so willing to enter into contractual relations with agents was that none was required to make large scale investments in transaction specific assets such as the physical assets including communications infrastructure and intangible assets including knowledge of the mechanics of the law of letters of credit, bills of exchange and foreign exchange dealings, the creditworthiness and standing of other banks in London (because of the highly centralized flows of information such as reputation of banks that were generated in key money market centres, particularly the City of London). By the 1960s, the degree of detail in each of the contracts with the hundreds of correspondent banks had increased, partly because of the need to comply with the exchange control regulations in Australia and elsewhere. Yet for all these changes, the basic nature of the contract was unchanged.

(ii) Monitoring and Selecting Correspondents. Banks did devote more resources to monitoring and selecting their correspondents. It is due to international banking involves various types of risk: credit risk, market risk, foreign exchange risk and interest risk,
however, the use of an agent introduces an additional element of risk - counterparty risk which can be increased dramatically if the agent behaves in an opportunistic fashion such as not honouring the letter of credit presented by the customer of the principal bank. By the inter-war years (1919-1939), the Anglo-Australian banks and other domestic Australian banks such as the National Bank of Australasia and the Bank of New South Wales had created embryonic “foreign departments” charged with the establishment and oversight of correspondent relationships. Visits to correspondents became more commonplace. It was these specialists in foreign or overseas departments who advised senior management on the agents’ credit limits. Those credits were related to the size and frequency of transactions, and they were subject to systematic monitoring. Australian banks discriminated amongst correspondents that they used. Some were trusted more than others. The way to ascertain the creditworthiness of agents as to the amount of credit that could be extended, depended on information that came from two sources: the published balance sheets of the correspondent banks, and their reputation and “standing with the respondents”. For instance, ES&A in the 1960s believed that 95 correspondents made up of major banks in United Kingdom, the USA, Canada and most of European countries were of “undoubted standing” and their letters of credit were accepted for unlimited amounts subject only to the discretion of the head office of the bank by the General Manager in Melbourne (Merrett, 1995). This arrangement was reviewed semi-annually in the light of the extent of usage, and the profitability to ES&A of the discount or acceptance facilities being utilized by the correspondents.

Discrimination between correspondents was according to credit rationalizing rather than price differentials to manage the risks inherent in the contract. The setting of credit limits reflected a combination of judgment about the strength of the other bank and the value of
correspondent business. This implied that the selection criteria of correspondents were risked rating, financial strength and the market reputation of correspondents. The reputation of correspondent banks also involved trust, which was a critical intangible asset in the banking industry, which was judged by markets through the completion of transactions or contracts.

(iii) Fees and Commissions. Fees and commission paid were significant sources of revenue as incentives for agents to complete their transactions or contracts that were borne by the customer of the principal bank. The fees appear to have been largely uniform (UBA, 1948 and Merrett 1995), for instance, all the Australian banks applied a common set of fees introduced by the London clearing banks from the late 1940s. Combining the percentage and flat rate fees suggests that the average rate of commission was around 0.5%.

(iv) Reciprocity. Principals were reluctant to direct business to agents that did not reciprocate, for instance, ES&A were unwilling to send business to her corbanks of US and Canadian banks who offered hardly any business in return in 1960s. Maintenance of good relationship with banker clients was in the interests of the agent or correspondents for other reasons, for instance, an agent could approach its respondent for information on the creditworthiness of other banks and customers.

(v) Changes of Corbanking Products and Services. Probably prior to 1960s, those corbanking services and products were clearing payments and collection, trade-related services and limited foreign exchange for settlement purposes which were settled through Nostro and Vostro accounts. However, by the 1960s, There was large business volume with a number of correspondents, particularly in London and New York, so that both parties, correspondents and respondents, had substantial balances with one another.
These accounts were no longer simply used to clear the payments and collections of bank customers, but were a part of wholesale inter-bank markets for credit and foreign exchange. New York agents were willing to make short term loans to a bank whose credit beyond question. Large compensating balances provided funds to the correspondent to employ in the overnight and short-term money markets. Furthermore, banks with a high reputation were more likely to be sought as partners in syndicated lending in the emerging Eurodollar markets.

(vi) Reputation. Bankers seldom resorted to the courts to enforce corbanking contracts with agents. Nearly all contracts were completed to the satisfaction of both banks because of the existence of powerful non-legal sanctions—reputation. Any bankers who behaved opportunistically or who could not honour contracts because of illiquidity or insolvency would forfeit their reputation. Banks with low reputation would be graded at low creditworthiness that made default likely, and that would have made their fund raising more expensive and their paper more heavily discounted by the market. Information flows of bank activities were transparent and almost instantaneous. The physical proximity of banks in the City of London and the constant professional and social interaction of bankers not only facilitated information gathering and dissemination but also placed a premium on reputation. Furthermore, any correspondent who gave inaccurate information concerning the creditworthiness of its own customers would lose repeat agency business not only from the bank it had wronged but from other banks as well. Reputation was a powerful deterrent to any correspondent to dishonour its contracts in the 1960s since heavy weights was placed on reputation for low probability of default.

(vii) Determinant Factors for Corbanking Relationships in the 1960s. Australian banks need agents at locations where they are not physically present in locations. There was no
lack of suitable correspondents for Australian banks in those locations. No evidence of the agency costs of correspondent banking, in the sense that agents might behave opportunistically, was particularly high. Corbanking is an effective way to test the foreign market for entry and a correspondent banking relationship had the potential to act as a beach-head into an alternative institutional mode, by providing initial funding and allowing the principal to accumulate knowledge about a range of businesses in foreign markets. Some of the reasons causing Australian banks to maintain their correspondents rather than changing to branches are as follows: Firstly, Australian banks did not possess what Dunning (1988) has described as ownership advantages in intermediation services that would allow them to compete successfully in foreign markets. Instead, Jones (1990) has stressed the worth of reputation to British banks as correspondents, and it is difficult to recreate knowledge and skills embedded in a foreign location. Secondly, Australian banks were too introspective and conservative after the major trauma of the 1893 banking collapses to even consider embarking on a multinational strategy before World War Two (Merrett, 1989). Thirdly, Australian bankers were culturally conditioned to limit their horizons to operating overseas in neighbouring Australian and British territories with their familiar legal systems, customs and language, and dealing with customers with whom the banks already enjoyed long-standing relationships. Finally, foreign governments came to exercise power of veto over the movement of bank branches across national boundaries from the inter-war period on. The ability of Australian domiciled banks to become multinational was reduced significantly by regulation imposed by many host nations, particularly after World War Two. Such restrictions were not loosened until the deregulation and liberalization of the financial markets in the 1970s and 1980s, nevertheless, bilateral agreements to have reciprocal branches are required till to-date.
Resurgence of Corbanking. In the 1950s to 1970s, correspondent banking was a simple business driven mainly by international trade finance. A correspondent bank merely acted as an overseas agent of another bank, for example in advising or negotiating letters of credit or acting as paying agent for drafts or remittances issued by another bank. Correspondent banking was uncompetitive then and the number of correspondent banks providing such services was limited. It was a desk-based job that did not involve much marketing. In addition, it was operated to provide support and reciprocity to other banks, to increase the banks' asset size and status without much emphasis on profitability. This enabled many small banks to make use of the free services of larger banks. These services were often not directly paid for but were compensated for by the maintenance of 'free' balances on deposit with the larger banks. From the 1970 onwards, there was a rapid change in the correspondent banking scene. International banks started establishing at a very fast pace in the major financial centres worldwide but arrived in Australia in mid 1980s. New communication technology and computerization improve the efficiency of the payment processing system. Banks look for more cost-effective use of cash balances, which leads to reducing the number of corbanking relationships and the balances held in their accounts. Interest rates became volatile and banks had declining profitability due to loan losses and declining spreads and thus the international requirements for equity backing lending have been established by BIS. As a result of these changes, banks which began to look for alternative ways to reach higher profit margins came to realize the potential growth and value of correspondent banking services. The globalization of trade and finance resulted in an expansion of international payment flows via booming foreign exchange markets. These opened new markets and profit opportunities to correspondent banks with banks acting as intermediaries for global capital flow. In addition, the growth
of foreign exchange markets and other treasury products have also elevated clearing and custodian services as important correspondent banking products. New services such as countertrade, swaps, options and futures increased in demand. Advanced technological developments, for example, worldwide electronic banking networks have facilitated the provision of financial services to other international banks. Many banks therefore look towards correspondent banking as a potential growth industry and have adopted a more aggressive approach to take advantage of this profitable area in particular via fee and commission incomes. Correspondent banking has now become a more competitive market, with profitability rather than reciprocity the main consideration. The banking environment provided for a resurgence of international correspondent banking. The new corbanking strategies that emerged resulted in a drive for new sources of income by introducing new products and repackaging existing ones. Correspondent banking relationships even developed further to be a strategy in the form of strategic correspondents and alliance, or inter-banks co-operation.

2.3 SERVICES AND PRODUCTS OF CORBANKING

Correspondent banking used to involve transaction services such as clearing and trade-related services as its core product. Little profit is earned in this service since the bulk of the business is based on reciprocity. However, in recent year, banks have come to realize that banker clients should be treated as normal corporate clients. Services and products should also be adjusted or tailor-made to suit banker client needs but cost and benefit needed to be weighed. Otherwise, selling standard products to those banker clients do not have further business potential, which is the way to have low cost for both parties. Many corbanking products and services such as advising letters of credit generate substantial fee
income, which can avoid the interest rate risk and hence provide steady income for banks. Fee income has thus become an important source of revenue. Recent technological advance and deregulation of the financial markets around the globe have led to rapid product innovation and to development in the area of correspondent banking. Traditional corbanking products - clearing and trade related services are still in existence, other products such as international syndicated loans, treasury services, custodian services and advisory services are growing in importance. International financial services relevant to international corbanking services defined by Ingo Walter (1988) embrace the following:

(i) Deposit taking from foreigners in onshore markets abroad and in offshore markets;
(ii) International trading and dealing activities in foreign currencies, deposits, forward-exchange contracts, financial futures;
(iii) Trade related services, comprising international documentary collections, letters of credit and acceptance financing;
(ii) Services associated with international lending activities, comprising lending in terms of secured and unsecured loans given to banks, individuals, corporations and governments, either in local or foreign currencies;
(iii) Securities markets services, comprising a range of services involved in underwriting and dealing in international securities issues of various maturities;
(iv) International personal banking, including the issue of travellers cheques and travel-related services;
(v) Financial advisory services to foreign firms, government agencies, central banks and individuals;
(vi) International trading and dealing in precious metals, particularly gold; and
(vii) International money transfers and collections.
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Corbanking services and products are based on the international financial services and reclassified as six important types of products and services, which will be discussed in paragraphs 2.3.1-2.3.6. Corbanking services can also be categorized as fund-based account services and fee-based trades finance and other services where the former class is interest-based business and the latter is non-interest based business. Furthermore, Certain correspondents are fundraisers for their respondents by providing wholesale funding raising products in capital and money markets.

2.3.1 Clearing and Payment Services

The global clearing and payment service has always been the core product of corbanking businesses. This service, which generates fee income for the bank, involves issuance and receipt of money settlements, on behalf of customers, arising from commercial activities that originated in or is routed through a banking system. A correspondent usually has large local settlement networks therefore acts as an overseas agent of another bank. To facilitate the transfer of funds, banks would maintain accounts-Nostro and Vostro to one another. Apart from providing reports which enable the bank to know how much currency has cleared through the account and what balances have to be maintained, banks today also provide elaborate management information systems to monitor all payments and credit limits. A significant development since the 1980s have been the change in the nature and volume of payments routed through various clearing systems. The proportion of commercial-driven clearing has declined considerably as banks try to keep up with new capital and money markets and increasingly view trading in foreign currencies as independent profit-making activities, not necessarily customer driven. New and improved
payment and clearing methods by latest communication technology also reduce the cost, increase speed and accuracy of delivery of these products.

2.3.2 Trade-related Services

Corbankers are likely to encounter trade finance transactions in the course day-to-day business which mainly provide fee and commission revenues. Variants of trade finance instruments range from the conventional-letters of credit and collection, through to forfaiting and countertrade financing where the spectrum of risk of non-payment to sellers range from open account trading to the use of the confirmed letters of credit is attached to them:

(i) Letters of credit. This is a written undertaking by a bank (the issuing bank) used for high exporters' risk, to the seller (the beneficiary) according to the instructions of the buyer (the applicant) to effect payment up to a prescribed amount within a prescribed time period against prescribed documents, provided these are correct and in order. In international trade, the correspondent acts as the agent for the issuing bank (normally the importer’s bank). It is sometimes the exporter’s bank too. It can be an advising and/or a confirming bank. By advising the credit, the bank has a responsibility to take reasonable care to check the authenticity of the credit, which it is being asked to advise. This service generates fee income for the correspondent bank.

(ii) Collections. A collection is used when the exporter is confident that litter risk of non-payment in existence in particular for a clean collection or a open account transaction where the buyer sends the purchase order and the exporter ships the goods without any other documents and involvement of a bank except using the bank’s payment system. In documentary collection, the transaction is similar to the clean collection but transport and
commercial documents holding title of the goods are required. A corbank holds the title documents until the importer either pays - documents against payment (D/P) or accepts the obligation to pay - documents against acceptance (D/A).

(iii) Forfaiting. A forfaiting is the purchase of obligations by a discounting bank (a correspondent) falling due at some future date, arising from deliveries of goods and services, mostly export transactions, without recourse to any previous holder of obligations. Forfaiting used to finance the exporting of major capital goods to firms in countries financing with payments to be made via a series of promissory notes or bills of exchange drawn in tranches (the taking or drawing down of an instalment of the sum agreed) and guaranteed by a bank in the importer's country. Hence, the correspondent is usually the exporter's bank who has a forfaiting agreement with the exporter to negotiate his promissory notes or bills of exchange at a discount.

(iv) A countertrade result from hard currency shortfalls faced by many developing countries such as Vietnam and Burma which lead to the use of natural commodities by importers as a payment medium to exporters. The supplier will have to accept his proceeds partly in cash and partly in goods for which he has no requirement. Exporters may be dealing with a quasi-government importer, operating through a central, a state bank or a government export agency, who is eager partially to compensate in less readily marketable products. Thus the correspondent 's job is to ensure the soundness of the contract via the bank's correspondent link with the state bank and to make contacts with other banks to find a buyer for the product offered in countertrade. A variety of documentation, including bonds, guarantees and complicated foreign exchange deals will have to be handled.
2.3.3 International Syndicated Loans

A syndicated loan is a large facility usually granted to a large organisations, government or government agency managed by an international bank, which is often the ‘agent’. A large number of banks participate both by lending money and/or by taking one of several different management functions, often in proportion to their importance as providers of funds to the syndication. A considerable fee is earned from this activity. Correspondent bankers, with their contacts with other bankers, supply services by finding suitable participants or themselves as a participant for the syndicated facilities.

2.3.4 Treasury services

Treasury services are mainly foreign exchange activities for commercial activities of respondents’ customers as for instance, international trade financing. Today trading with accounts of respondent banks become important corbanking businesses. A large and reputable correspondent bank is involved in selling the bank’s treasury products, settling foreign exchange and money market lines and establishing limits for the bank’s counterparts. These counterparts are usually smaller banks who find it profitable to make use of the larger bank’s services rather than operating the services on their own. The larger bank as the correspondent banker thus puts up credit analysis on the smaller banks and gives the permission to trade them within some credit limits.

2.3.5 Custodian services

In custodian services, the correspondent agrees to act as a ‘guardian for its customers’ goods’. The primary purpose of a custodian has expanded therefore from its humble trade settlement and certificate safekeeping function to offering a full suite of services that can include: transaction settlement; asset safekeeping; income collection; corporate action
processing; foreign exchange conversion; proxy voting; cash management; securities lending; performance measurement; and comprehensive multi-currency reporting. While these services may not be required by all buyers, it is evident from the way the market is developing, that if custodians cannot provide a full range of services, they may not participate in the larger mandates that become available. On the basis that fee margins are relatively low, the business has become volume dependent in order to achieve any sort of meaningful return, and therefore 'limited service' providers, have limited growth potential and possibly even limited life span. Australia has seen significant improvement over recent years with the former paper and labour intensive procedures being replaced with world-class electronic processes such as Austraclear, and RITS. These involved Australian banks in high costs as they developed straight-through process capabilities. Upgraded efficiencies in the settlement process coincide with significant customer pressure for fee reductions.

2.3.6 Advisory Services

The advisory services covers very wide range according to the strength of business of correspondent banks. These services include full consultancy service to other banks that wish to venture into the capital market and start a capital market operation in Australia. Fees and commission and sometimes goodwill are generated from these services. A correspondent also provides advice on existing products and services at no extra charge. The main aim is to generate good relationships with other banks wishing for future reciprocal or partnerships businesses.
2.4 CHARACTERISTICS: TRADITIONAL AND CONTEMPORARY

The correspondent banking activities of many Australian banks have changed dramatically over the past fifteen years. Previously, a correspondent relationship often only involved single products or transactions. The correspondent banker of the past was a product-specialised account manager whose job was to open and maintain *Nostro* and *loro* accounts and to monitor reciprocity. This somewhat isolated product and transaction-oriented approach tends not to encourage cross selling. Once a year, the relationship between banks was topped off by mutual courtesy visits to each other's head offices. Correspondent banks were looked on as competitors, not as clients. Much tougher competition, the increasing importance of credit risk, pressure to obtain higher, risk-adjusted returns and new technology have engendered a far more efficient and results-driven approach. Other banks are no longer considered as competitors. They are part of the attractive 'financial institutions' client segment. The product-driven style of corbanking has gradually been replaced by a systematic, professionalised and marketing-orientated approach. Financial institutions, client segment covering banks, bank-like institutions, brokers, insurance companies, asset managers and pension funds, have become as important as Corporate clients. Coverage of the client segment is based on the principle of long-term relationships.

The typical correspondent banker has become a sophisticated and skilled relationship manager, trained in marketing and able to sell a wide range of services from plain vanilla products to tailor-made, highly structured solutions. He or she is responsible for the management of the client relationship and establishing a tailor-made product mix in close
co-operation with product specialists. Therefore an extensive knowledge of all products offered to financial institutions is a key requirement for every relationship manager.

The traditional functions of corbanking were virtually transactional, but the main functions of contemporary corbanking are:

(i) As an intermediary role for global capital and balance sheet capacity. The location of loan assets does not correspond to the location of a bank’s capital. Mega-deals require effective asset distribution capability and BIS requirements send banks in search of new capital. Corbanking will effectively mediate the supply of capital with the demand for loans.

(ii) Sharing the costs of operations and capacity - economies of scales. Over capacity in banking operations causes banks to operate inefficiently where a solution would be to pool operations and reduce costs via corbanking.

(iii) As a conduit for cross-border business. Trade growth will continue and users of corbanking require greater efficiency in order to improve their competitiveness via less expensive paths than LC-open account trading, bank data exchange and SWIFT.

(iv) Pooling of credit and financial information. Technology and global markets broaden the arena for possible fraud and money laundering. Corbanks act in a spirit of cooperation and mutual protection which could reduce fraud and money laundering.

(v) Substituting for global branching. Corbanking is the cheapest method for international banks to establish points in certain countries or cities without capital commitment. Corbanks can not serve effectively as a global branch network but this is the best method where the number of transactions of businesses does not justify for international banks having branches in terms of costs and benefits in particular countries or cities in question (Summersfield, 1997)
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The traditional and modern characteristics of corbanking are compared and contrasted in the following table (Witkins, 1991):

Table 2.1 Comparing traditional and contemporary correspondent banking

<table>
<thead>
<tr>
<th>Traditional</th>
<th>Contemporary</th>
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</thead>
<tbody>
<tr>
<td>Non-Specialist, linked to payment</td>
<td>Specialist, marketing function</td>
</tr>
<tr>
<td>A cost centre, for semi-retired bankers</td>
<td>A profit centre</td>
</tr>
<tr>
<td>Reciprocity</td>
<td>Fee based and commission driven</td>
</tr>
<tr>
<td>Transactional, desk-bound, problem solving</td>
<td>Relationship</td>
</tr>
<tr>
<td>Dependent on name &amp; trust on other banks</td>
<td>Dependent on risk analysis</td>
</tr>
<tr>
<td>Free Nostro/Vostro balances</td>
<td>Profitability, cost per item transactions</td>
</tr>
<tr>
<td>Client bank as colleague/friend</td>
<td>Client bank as customer</td>
</tr>
<tr>
<td>Payment and clearing, &amp; Trade Finance services</td>
<td>Multi-products based clients’ needs</td>
</tr>
<tr>
<td>Accounts with any bank</td>
<td>Focus on a targeted customer base</td>
</tr>
</tbody>
</table>

Contemporary corbanking is developed further due to expansion of dynamic banking to financial services involving competition, technology advancement such as e-banking/internet banking and e-risk, globalisation, movement of capital funds, merger and acquisition of financial institutions, deregulation and de-intermediation. These will change the pattern of how corbanking to be operated and managed. Rationalisation of number of corbanks is not just to reduced cost and number of corbanks but also to enhance service efficiency and quality, for example, single European currency does not therefore require more than one corbank for currency business but this may not be true for other financial services business.

2.5 CONCLUSION

Generally, correspondent banking relationship is a contractual relationship between banks: the conduct of business in a country or market in which a respondent has no
physical presence. This is probably the genesis of correspondent banking as the name suggests. International trade and payment brought with it the necessary for international payment and letters of credit. Correspondents become necessary to effect timely payments in different jurisdictions. Banks preferred to use correspondents to settle their transaction services while intermediation services across borders are more suitable by a multinational branch. It is not easy to separate corbanking services from other banking services since corbanking services used to support and be integrated into other banking services. Banks always have to be correspondents as well as respondents.

Correspondent banking in its traditional form has been part of the Australian banking scene since the 1830s. Initially the number of correspondents used by the Australian banks was small and concentrated in UK, reflecting the very close trade and capital flow between the two countries. Today each of the major Australian commercial banks works with a sizeable network of correspondent relationships around the globe. The extent to which each of the Australian banks maintains an international presence will determine the level of need for correspondent banking services. Prior to 1970, no Australian bank established a branch elsewhere in the world (Merrett, 1995, page 72). Australian banks therefore used correspondents to provide cross border financial services. For contracts and costs, theories: transaction-cost economies and principal-agent might be used to explore issues like the choice of organisational structures and contractual relationships leading to why the correspondent arrangement was used (Milgrom and Roberts, 1992, Williamson 1979). Although, in practice, transaction costs of some international banking transactions may be reduced by correspondent banking services, in theory, the costs of international banking transactions were reduced by using overseas branches whereas internalisation may not necessarily have reduced transaction costs (Jones, 1993).
Chapter Two

Reputation is a very powerful tool to ensure correspondents’ completing contracts. However, costs of the agency were increased according to the limited choice of correspondents and the volume of the transactions. An important advantage of corbanking is the fact that large-scale investment in transaction specific assets is not required for correspondent relationships. For monitoring and selecting correspondents, banks devoted resources to monitor their correspondents because of various risk in particular counterparty risks. The selection criteria of correspondents were risk rating, financial strength and market reputation. For fees and commissions, they were significant sources of revenue of agents and rather uniform from the late 1940s. For charges of corbanking products and services, prior to the 1960s, corbanking services were clearing and trade-related services, large compensating balances provided correspondents with the resources to invest the funds to money markets and for syndication lending in the Eurodollar markets. For determinant factors for corbanking relationships in the 60s in addition to the previously mentioned transaction cost, reputation and minimum capital investment were locations and not physically present. Furthermore, Australian banks (i) did not possess Dunning’s ownership specific advantages in intermediation services, (ii) were conservative, (iii) limited themselves to countries with their familiar legal systems, customs and language, and (iv) were restricted by foreign government to set up branches for establishment multinational branches. For resurgence of corbanking, with a competitive financial environment and declining profitability due to low credit requirements and declining spreads, Bank of International Settlement’s 8% minimum capital adequacy requirement on risky lending, financial institutions looked for alternative ways for higher profit and lower risk. Deregulation and technology advance allow innovation of financial products and services. With theoretical backing such as
Dunning's Eclectic Theory (1979) and Transaction Cost Theory, Corbanking networks were thus identified as an alternative with the characteristics of fee income and low risk services. Main corbanking products are clearing and payment services, trade-related services, international syndication loans, treasury services, custodian and advisory services which may be non-financial services. The evolution of modern corbanking reveals that the restriction of creating new or packaging corbanking products are reduced since corbanks require to provide only services to satisfy needs of respondents in competitive environment. Many banks have used corbanking as a strategy tool which could be in the form of strategic correspondents, alliances, co-operations and joint-venture. Although corbanking could provide tailor-made products, cost and benefit have also to be considered. Standard products are very economical for many short-term businesses.

The traditional functions of corbanking are transactional but contemporary corbanking is more than transactional. It includes an intermediary role for global banking, sharing costs of operations, being a conduit for cross-border business and trade growth, pooling of information and substitution for global branching. Traditional and contemporary characteristics of corbanking are then compared and contrasted as follows: Modern characteristics include - a profit centre, fee based business, long-term relationships, profitability and multi-products based on client's needs. Traditional characteristics include - a cost centre, reciprocity, transactional business, interest free balances, limited to payment and trades finance products. Contemporary corbanking is further pushed forward by expansion of dynamic banking to financial services. Rationalization of number of corbanks is not just to reduce cost but also improve service efficiency and quality.