An empirical study of international correspondent banking in Australia

Soon-Lim Chan
University of Wollongong


This paper is posted at Research Online.
NOTE

This online version of the thesis may have different page formatting and pagination from the paper copy held in the University of Wollongong Library.

UNIVERSITY OF WOLLONGONG

COPYRIGHT WARNING

You may print or download ONE copy of this document for the purpose of your own research or study. The University does not authorise you to copy, communicate or otherwise make available electronically to any other person any copyright material contained on this site. You are reminded of the following:

Copyright owners are entitled to take legal action against persons who infringe their copyright. A reproduction of material that is protected by copyright may be a copyright infringement. A court may impose penalties and award damages in relation to offences and infringements relating to copyright material. Higher penalties may apply, and higher damages may be awarded, for offences and infringements involving the conversion of material into digital or electronic form.
CHAPTER FOUR: LITERATURE REVIEW

4.0 INTRODUCTION

This is the third background chapters for the core of the empirical research work in chapters six to eight. The aim of this chapter is to review the literature on international corbanking in order to build theoretical constructs for the case study in chapter six, the empirical surveys in chapter seven and determinant factors of corbanking relationships as well as selection criteria of correspondents in chapter eight involving exploration of corbanking activities, practices and management in Australia. The Australian corbanking literature consists of Merrett’s (1989) history of Australian corbanking research article – “Australian Banking Practice and the Crisis 1893” (discussed in the chapter two above) and three contemporary corbanking publications: two conference papers by Chan and Naughton (1995 and 1996) and one journal paper by Naughton and Chan (1998). The dearth of academic research on international corbanking in an Australian context has already been noted. It is thus difficult to build a theoretical framework for Australian corbanking system analysis. United States empirical studies will be used to supplement these deficiencies but only partially because of the different banking environment and system in the United States. The limited literature will provide a starting point which is supplemented by direct input from senior bank officers of all banks in Australia through interview and completion of questionnaires in order to form a basis for this research. This literature review will be subdivided into immediate discipline (focus theories) of the research areas -international correspondent banking in section 4.1 and parent disciplines (background theories) - international banking, general banking and organisation theories.
in section 4.2 (Perry, 1994). The summary and conclusion of the literature review is in section 4.3.

4.1 IMMEDIATE DISCIPLINE - International Correspondent Banking

This is the direct corbanking research literature. There is a dearth of theoretical literature on correspondent banking in the Australian context. Most of the academic studies in the area of International Correspondent Banking are in the USA regulatory environment which is operating in different unit banking systems depending on the openness of the individual states. Furthermore, most studies are related to compensating balances, which are becoming less important for modern corbanking. Five models (paragraphs: 4.1.1 to 4.1.5) of Correspondent Banking Relationships in the literature are reviewed, summarized and analysed. In addition, the criteria for selecting correspondents in practice are also included in paragraph 4.1.6 of this literature of immediate discipline.

4.1.1 Bank Size (Lawrence and Lougee, 1970)

A survey was conducted on the use of corbanking services by 262 respondent banks in the Denver major trading area consisting of Colorado, Wyoming and New Mexico which operate the Unit Banking System. Banks in this study were small with assets ranging up to $83 million. All banking subsidiaries of registered holding companies were excluded from the analysis. The median bank size was $44.5 million.

Two sets of dependent variables were considered:

(I) The Number of correspondent ties that banks maintained:

   (i) The total number of correspondents. The remaining variables under this head consist of the number of correspondents in several geographic regions,
(ii) Number of ties in Denver,

(iii) Number of ties outside Denver but within the Denver major trading area,

(iv) Number of ties in adjacent commercial centers in which a Federal Reserve Bank or one of its branches is located, (v) Number of ties in distant commercial centres.

(II) Total Balance Due from domestic banks:

(i) Due from Correspondent Only, and

(ii) Due from correspondents and balances at the Federal Reserve Bank.

Two sets of independent variables were also examined:

(I) Bank Characteristics Variables, which include

(i) Bank Size,

(ii) Bank's size rank in its home office city,

(iii) The bank's ratio of demand to total deposits,

(iv) Bank's Federal Reserve membership status (Dummy variables).

(II) Geographic Variables which include:

(i) Population of home office city,

(ii) Distance from Denver and

(iii) Banks location (Dummy variable).

The study concluded that the bank size, the bank's ratio of demand to total deposits and the distance from the major commercial centre are important explanatory variables.

The bank size is the single most important explanatory variable for explaining differences in the total number of correspondent ties and the geographic distribution of those ties. The result also suggests that almost every bank requires correspondent services from a bank located in the commercial center of the relevant major trade area; but only larger
banks (over $50 million in deposits) are likely to have more than one correspondent in the major centre. On the other hand, most of the very small banks either have no need for correspondents in adjacent and distant commercial centres or do not use them if needed because of cost considerations or the difficulty of obtaining such services.

The second most important variable was the deposit structure shown by the ratio of demand to total deposits, which indicates greater needs for check processing services.

For geographic variables, the distance of the bank from the major commercial centre and the ratio of demand to total deposits influence the number and geographic distribution of correspondent relationships as well as total correspondent balances.

The results from this study required interpretation prior to being applied to the entire correspondent banking system because of the very small nature and unit banking system in Denver area. This study is basically a survey of the provision of basic payments system services to a large number of small banks. The very small nature of the average bank in the sample undoubtedly precludes the demand for specialised business services.

In terms of cost savings by profit function using United States data, larger banks appear to be substantially more efficient than smaller banks which may offset scale diseconomies found elsewhere (Berger, Hancock & Humphrey, 1993). Therefore, the bank size factor seems relevant to efficiencies and competitiveness of financial institutions. However, cost savings of mergers are rather consistent for bank mergers (Horizontal mergers-Rhoades, Megamergers-Shaffer, 1993), that is the combined organisation can reduce operating expenses. The rationale for this argument is that horizontal bank mergers would permit the reduction of costs through consolidation of back office and administrative functions, cutting employees, reducing branches and so forth. Nevertheless, such reductions in costs do not necessarily increase efficiency. That is, such reductions in costs may be
accompanied by corresponding reductions in assets, which represents shrinkage of the firm rather than improvements in efficiency. Most inefficiencies are from deficient output revenues, rather than excessive input costs (Berger, Hancock and Humphrey, 1993). Horizontal bank mergers did not generally result in efficiency gains. However, predictions of efficiency gains can be made from improvements in management and operations as opposed to scale economies. These efficiency gains have implications for the long-term performance of the industry (Rhoades, 1994). In other words, acquiring institutions in mergers and maintaining their productivity advantage subsequent to the merger tend to be more productive than the average. By implication, if mergers can be generally characterized as the acquisition by a relatively more productive bank of a relatively less productive bank, then industry performance should improve as a result of these mergers (Fixler and Zieschang, 1993). Most international Banks with larger bank size probably have a larger international branch network including at least one branch in major currency’s countries. Those branches are established if it is purely based on commercial rationales such as sufficient business volumes and activities rather than political reasons. However, large corbanking networks may still be maintained for existing or new activities which can not be effectively and/or efficiently handled, such as specialized services or funds require to be transferred to small towns, by those banks.

4.1.2 Liquidity (Dewald and Dreese, 1970)

This study is related to demand for liquidity. Dewald and Dreese examined various sources of liquidity available to 18 member banks in the Cleveland Federal Reserve District. The sample consists of 18 banks which were classified as “willing to borrow” from the Federal Reserve. Five dependent variables were:
(i) Federal Reserve borrowing, (ii) Due from Balances, (iii) Excess reserves, (iv) Free reserves and (v) Free reserves and correspondent balances, and four independent variables were: (i) Total deposit variability, (ii) Random deposit variability, (iii) size and (iv) loan to deposit ratio.

The analysis uses 1,701 observations of the daily values of total loans, deposits, reserves, Federal Reserve borrowing and Due from balances measured by Due from balance/Total Deposit are the data used for the analysis.

Total deposit variability is simply the standard deviation of deposits, while random variability is total variability after seasonal and trend factors have been removed.

The conclusion is that the random deposit variability explained the Due From balances for the demand of liquidity. Total deposit variability, the size and the respondent's loan-to-deposit ratio was not significant variables. Since Due From balances are significant factors for indicating the state of corbanking activities and strength of corbanking relationships, the random deposit provides liquidity to Due From accounts, implying that liquidity is a possible determinant factor for corbanking relationships. International corbanks as sources of liquidity in particular for foreign currencies are commonly arranged, these arrangements also lead to corbanks involved in syndication loans generated by respondents.

4.1.3 Liquidity and Services (Meinster and Mohindru, 1975)

The study was based on 65 banks in Pennsylvania, New York and New Jersey excluding the Philadelphia and New York metropolitan areas. Meinster and Mohindru provide two reasons for maintaining balances held with correspondent banks by small and medium size banks: (i) correspondent balances furnish respondents with protective portfolio
liquidity and (ii) these balances are one means of payment for certain correspondent services (direct fees being the other). They combine the motives of demand for correspondent services (studied by Lawrence and Lougee, 1970) with the demand for liquidity (studied by Dewald and Dreese, 1970). Their hypothesis is that a respondent’s motives for maintaining balances is the same as that of firms who maintain compensating balances with banks. They consider compensating balances as active (or voluntary balances for liquidity reasons based on Hodgman, 1963 and David and Guttentag, 1963) and passive (or involuntary balances for firms borrowing at preferential rates and correspondent services). They view the decision of respondents to hold a given level of balances to be made jointly as they decide upon overall levels of cash assets including vault cash and balances due from the Federal Reserve. Furthermore, Correspondent services are viewed as augmenting a respondent’s profit in the following ways: (i) Deposit augmentation (Check clearing, trust services, loan participations, etc) and (ii) Increasing return on assets (portfolio analysis, Federal funds transactions, etc).

The estimating model is provided in the form of a simultaneous equation model:

\[ C/T = f(R^*/T, D/T, SD/T, \rho, S/T) \]

\[ R/T = g(C^*/T, D/T, SD/T, \rho, F) \]

where:

- \( C \) is correspondent balance demanded by the respondent bank
- \( T \) is total deposit
- \( R^* \) is estimated level of the sum of vault cash and Fed deposits
- \( C^* \) is the estimated level of correspondent balances
- \( D \) is demand deposits
- \( SD \) is the standard deviation of demand deposits
- \( \rho \) is the yield on average assets
- \( S \) is the costs of correspondent services
- \( F \) is the dummy variable representing Federal Reserve membership

Six dependent variables were defined as follows: a) Total DF balances, DF/T; b) Primary DF balances, DF1/T; c) Secondary DF balances, DF2/T; d) Minimum DF balances,
DFmin/T; e) Variable DF balances, (DF - DFmin)/T; (f) Variable primary DF balances, (DFmin - DF2)/T; For a) and e), the level of total cash assets (VC + DFed) and return on assets (p) were negatively related to DF/T and significant. The deposit structure (D/T) and deposit variability was significant and positively related.

The disaggregated service variable representing cheque processing, S1 was significant in explaining the level of minimum balances as well as the level of variable primary balances. This implies that the balances as indicators of corbanking activities or of the strength of relationships are financed by check processing for liquidity, in other words, liquidity is a factor for corbanking relationships. The second part of this survey looked at the demand for seven separate correspondent services which were: a) Check processing, b) Security safekeeping, c) Portfolio analysis, d) Personnel training, e) Foreign transactions, f) Federal funds trading and g) Loan participation. For the level of primary balances and the minimum level of balances, the check-processing coefficient alone was significant. The check processing and loan participation variables were significant in explaining the number of secondary correspondents.

4.1.4 Economies of Scale (Gilbert, 1983)

The economies of scale literature in general (such as publications by Gold, 1981, Lieberman, 1987, Aivazian, 1987) and banking (such as publications by Beston, Hanweck and Humphrey, 1982, Gilbert, 1984, Humphrey, 1992 and OECD, 1992) is vast. Assuming all factor inputs are variables, a firm is said to exhibit economies of scale or scale economies when equiproportionate increases in factor inputs yield a greater than equiproportionate increase in output. Scale economies is a long-run concept, applicable when all the factor inputs which contribute to a firm's production process can be varied. Thus, if a firm is burdened with capital, property, or labour which are fixed, then economies of scale do not apply (Hefferman, Salvatore both 1996). The only relevant
study that covers economies of scale in international corbanking in Gilbert (1983).

Furthermore, the term, economies of scope refer to the lowering of costs that a firm often experiences when it produces two or more products together rather than producing each product separately which is relevant to the economies of scale (Teece, 1980, Clark, 1988, OECD, 1992). However, in this research, economies of scope is included in the economies of scale. Again, association between correspondents and respondents may be used to give correspondents economies of scale in marketing and distribution of services, research and development and so on across the full spectrum of international banking services (Beamish, Morrison, Rosenzweig, 1997).

Gilbert’s study (1983) investigated economies of scale in terms of a relation between the scale of a correspondent bank’s services to respondents and the short-run variability in its demand balances due to banks in the four market areas: Arkansas, Illinois and Missouri, Indiana and Kentucky, and Mississippi and Tennessee served by the four offices of the Federal Reserve Bank of St. Louis. A bank that serves as a correspondent for a large number of respondents has greater short-run stability in its total demand balances due to banks, and therefore, lower transaction costs in managing its reserve position than if it served fewer respondents. The findings are that the relatively high concentration in the correspondent banking industry reflects economies of scale that result from a negative relation between the total demand balances of corbanks due to respondents and the variability of those balances. In contrast, there is no relation between the total demand deposit liabilities of a bank due to its private, non-bank customers and the variability of those deposits. These results provide a basis for considering correspondent banking services separately from other banking services in analyzing economies of scale or concentration in local banking markets. Correspondents and respondents involved in
liquidity arrangements leading to other services which are common in banking business. It is due to both banks understand each other ways of doing business including the level of risk they are taking.

4.1.5 Profitability and Cost (Knight, 1976)

Knight reported the results of the survey of 107 US banks for the period August-September 1975 nationwide for account analysis for profitability measure in correspondent banking. The survey found wide differences among correspondents in charges for services. Banks have tended to cost and price only a small group of standard activity services, others have been offered without charge. Banks do not know their costs and tend to establish unrealistically low charges. According to the survey, it evident that a significant proportion of correspondents were providing at least some services at prices below estimated costs. Banks experiencing losses on services often had lower prices than those which found the service profitable. Interestingly, loss-making banks almost always had higher estimates of costs than other banks. Numerous factors are responsible for the wide variations in the prices of correspondent services and the practice of some banks to charge prices below estimated costs. These include varying degrees of bank competition, marketing objectives, alternative approaches to costing services, as well as actual differences in costs. Competition would still focus on the quality and range of services available, but the prices of services would become much more significant. Perhaps fees would tend to replace balances as the standard means of compensating correspondents for services. If corbanks have an accurate measure of the direct costs of providing standard
operating services, will they be able to make intelligent decisions regarding the
profitability of respondent bank relationships and services.

4.1.6 Selection Criteria (Choo, 1989 and Krishnan, 1990)

There is no academic study related to the identification of international correspondent
banks. Nevertheless, Choo (1989) and Krishnan (1990) in their technical conference
papers examine criteria or vital considerations for selecting key correspondents. Analyses
are summarized at last few paragraphs of the two studies:

(1) Choo’s Selection Criteria (1989)

Choo urged that there be no standard formula of criteria for selection in general. The
selection of correspondents is based on banks’ profiles and overall business niche and
policy. He noted eight (8) criteria for selection correspondents:

(i) Quality of Management: one of the major driving force in any business is the
quality of management and associated attributes: competency, integrity, stability, vision
and support;

(ii) Financial Resources, Quality and Stability: it is insufficient just to look at the asset
sizes of banks, we should also consider asset quality and capital adequacy of corbanks and
such consciousness is even more relevant if the bulk of business conducted with the
respondent is credit related;

(iii) Products and Services: respondents do not require the whole range of products and
services that numerous corbanks are offering since demand would depend on the core
business that these respondent banks are active in, as well as whether it fits into their
strategic business niches. He recommended respondents to categorise key correspondents
into types of more commonly used credit and non-credit related services for price
comparison among correspondents. Nevertheless, the choice of correspondents must be evaluated against correspondents' abilities to minimize operational errors; speed in responding to problems and resolving them efficiently and amicably; and flexibility and speed in responding to changes in customers' requirements;

(iv) Effective Account or Relationship officer(s): abilities to possess good knowledge of the customer base and the products/services offered as well as to ensure effective follow-up in resolving problems and responding to enquiries;

(v) Consistent Business Policy: this policy should be demonstrated to ensure long term continuity of services. However, events beyond the control of correspondents may eclipse such business policy in the long run;

(vi) Reciprocity: it is an important bargaining tool and perceived to be an important contributor to the bottom line. However, it is difficult to ensure reciprocal funding support and exchange of business which require correspondents to have adequate co-ordination and co-operation at all operating levels, an effective information system to track and monitor global funding support and business exchange, commensurate authority and backing to be given to the Correspondent Banking Department and sufficient top management support;

(vii) Broad Domestic and Global Branch Network: these are very useful for international banking transactions. However, there have been conflicting opinions on the operational service advantage as opposed to the perceived competition that the local presence of a correspondent may pose;

(viii) Technology: it should reach a level which respondents require correspondents to fulfill in respondent requirement. Many corbanking businesses would be technologically
driven. Overlooking this would compromise on the overall speed, efficiency and quality of services offered.

Choo also mentioned the choice of number and size of key correspondents. Larger size banks can provide comprehensive banking services comparing with smaller size banks, however, small banks may be able to provide specialist services. All correspondents cannot be all things to all banks although there is evidence of some major banks achieving relative success in establishing this niche. On the other hand, there is also evidence of small/medium-sized banks providing excellent levels of service that fit well into the limited requirements of some correspondents. Where appropriate, it would be useful to have more than one key correspondent in each country. However, maintenance costs will be incurred in order to keep corbanking accounts and arrangements. Too many corbanks will also have difficulty to give reciprocal businesses to all corbanks. Therefore, the number and size of corbanks are not crucial but carrying out international financial services effectively and efficiently with optimum cost should be the bottomline to achieve.

(2) Krishnan’s Selection Criteria (1990)

Krishnan basically used Palmer’s (1990) ideas to define the main objective of the buyer of corbanking services, which should be to maintain global relationships with the minimum number of banks providing the maximum number of services. A corbanking service buyer pays by a combination of fees and balances as interest rates move in its favour. He further considers fourteen (14) criteria as vital for selection of correspondent banks:

(1) A Formal Banking Presence in the Country: customers do not wish to do business where the transaction-initiating bank is not presented in the country. A global network of offices would also be useful.
Range of Services provided: corbanks must have services to meet the requirements of the respondents.

Local Decision-Making Authority for Credit Services.

Linkage to SWIFT, CHIPS, CHAPS and/or Private Netting Systems.

Liberal Risk Attitude on Daylight Overdrafts.

Operational Capabilities.

Historical relationship.

Competitive Pricing.

Financial Strength of Corbanks.

Reciprocity: becoming less fashionable and modern approach to reciprocity includes bilateral pricing agreements, strategic alliances and technological co-operation.

Good Service and Effective Product Delivery.

Communications/Reporting Capabilities: they should be efficient and timely.

High Calibre Corbanking Officers: they are to maintain client banks as customers.

Innovative in Product Design.

A combination of Choo and Krishnan’s selection criteria and further opinions from bankers in Australia form the basis of the possible criteria to select corbanks used in this thesis.

4.2 PARENT DISCIPLINE - International Banking and General Banking Theory, and Organisation Theory

International banking is a wider concept than just corbanking. It includes all forms of foreign trade finance and cross-border lending and borrowing. Multinational banks, which own and control branches and/or affiliates in more than one country, have direct access to the international banking system. Nevertheless, trade finance and cross-border
lending can be, and often is conducted without multinational banking. International banks can operate in foreign markets through correspondent banks or a combination of their own branches and corbanks (Wilkins, 1993). There is no direct theoretical framework for banks to engage in international banking via correspondent banking. The eclectic theory of international production (Dunning, 1979) commonly used for multinational enterprises can be a useful theoretical framework of globalization for banks as strategies to develop their international banking and multinational banking (Gray and Gray, 1981). However, Shapiro (1992) takes a simpler view of strategy formation for international expansion by using corbanking as an expedient to be used until the volume of business in a foreign country justifies upgrading to representative office or branch/subsidiary status. Transaction cost and Principal-agent theories of organisation are useful to reveal the underlying reasons for using corbanking mode. Brief literature review on Relationship banking will also be carried since it is a growth area of corbanking.

4.2.1 Dunning’s Eclectic Theory (1977)

The Eclectic paradigm is a micro-economic theory of foreign direct investment and an important theory to explain foreign activities of firms. The eclectic paradigm was first put forward by Dunning (Dunning1977). There has been a number of modifications since it incorporates to a certain extent other two theories: internalization theory and Macro-economic theory of foreign direct investment (Kojima, 1973,1978,1982,1990, Ozawa, 1984). Although it is a theory for international production, it can also be applied to service activities (Dunning, 1993).

Eclectic Theory has been subjected to two main criticism. First, it offers only a snapshot view of the multinational enterprise (MNE), or at best, compares the propensity of firms and/or countries to be international direct investors at different time periods. Therefore,
there is no dynamic theory of MNE activity. Second, neither paradigm satisfactorily takes account of the strategic response of firms as an independent variable affecting the scale nor scope of foreign value-added activities. In other words, couched in a neoclassical framework, and working on the assumption of profit maximization and very limited uncertainty, it is implicitly assumed that two or more firms faced with an identical ownership, location and internalisation (OLI) configuration would react in the same way.

The eclectic paradigm (Dunning, 1979, 1993) of international production sets out a generalized framework for explaining the level and pattern of the cross-border value-added activities of firms. The main tenets of the paradigm are that the level and structure of a firm’s foreign value-adding activities will depend on the following three conditions being satisfied:

(i) The extent to which it possesses sustainable ownership-specific (O) advantages vis-à-vis firms of other nationalities in the particular markets it serves or its contemplating servicing. These O advantages largely take the form of the privileged possession of intangible assets as well as those which arise as a result of the common governance of cross-border value-added activities. These advantages and the use made of them (refer to ii and iii below) are assumed to increase the wealth creating capacity of a firm, and hence the value of its assets.

(ii) Assuming condition (i) is satisfied, the extent to which the enterprise perceives it to be in its best interest to add value to its O advantages rather than to sell them, or their right of use, to foreign firms. These advantages are called market internalization (I) advantages. They may reflect either the greater
organizational efficiency or hierarchies or their ability to exercise monopoly power over the assets under their governance.

(iii) Assuming conditions (i) and (ii) are satisfied, the extent to which the global interests of the enterprise are served by creating, or utilizing, its O advantages in a foreign location. The distribution of these resources and capabilities is assumed to be uneven and, hence, depending on their distribution, will confer an L advantage on the countries possessing them over those who do not.

To add strategic consideration into the application of eclectic theory, given the configuration of the ownership, location and internalization (OLI) advantages facing a particular firm, the extent to which a firm believes that foreign production in consistent with its long-term management strategy.

The Eclectic Paradigm is applied as a global strategy of multinational enterprises, which can be applicable for correspondent banking. In this context, the paradigm postulates that absence of the three advantages (OLI) may cause banks in Australia to use correspondents overseas rather than a branch or a subsidiary. In short, Dunning formulated his theory in the following way: Given the possession of net ownership advantages over local firms, the most profitable development for the multinational is to internalize them by extending its own activities. It must then be beneficial for the multinational to combine these internalized advantages with some factor inputs in some foreign countries, otherwise foreign markets would be served entirely by exports and home markets by home production.

Gray and Gray (1981) argued that focusing on a mix of internalization and location factors is sufficient to have multinationality. Yannopoulos (1983) builds on and refines the preceding effort by Gray and Gray and further specifies location-specific, ownership-
specific, and internalisation-advantages, which are essential ingredients of multinational banking, but, again, these three specific advantages are generally not in existence for banks in Australia. However, in Merrett's (1995) view, Australian banks did not possess ownership advantages in intermediation services that would allow them to compete successfully in foreign markets. Furthermore, the same level of productivity, knowledge and skills may have been difficult to recreate in overseas markets as location and internalization advantages are not present.

4.2.2 Transaction Costs - Benston and Smith (1976)

Transaction cost can generally be explained by the transaction-cost economics theory (Commons, 1934 and Coase, 1937, Williamson, 1979). Different organisational forms and institutional and contractual arrangements represent different solutions to the problems of coordination and motivation. These problems give rise to transaction costs, which are the costs of negotiating and carrying out transactions including the cost of coordination and motivation. Transaction cost theory holds that organisations are designed to minimise the total costs of transacting. The two problems with this theory are that the costs of transacting are not logically distinguishable from other costs, and that efficiency itself does not always imply total cost minimization.

In transaction cost of banking, Geoffrey Jones (1990) alluded to transaction cost economics in explaining the choice among exporting, branching and using correspondents for international financial services overseas. Merrett (1995) applied transaction cost to interpret international corbanking as the preferred choice of institutional modes for the particular transactions. Prior to 1960, transaction costs for the then simple payment and trade finance of international corbanking services were remarkably low because the contractual relations between principal and agent were straightforward, reputation
Chapter Four

reflected credit standing, limited regulations controlled banks and thus the corbanking system worked well. Nevertheless, more underlying factors of transaction costs, such as credit standing based on business performance, prudential control by Reserve Bank of Australia and efficiency of banks, are getting more and more complicated leading to increasing transaction costs from the sixty to new century.

Importantly, Benston and Smith (1976) consider transaction costs as being central to the theory of financial intermediation. They argue that the justification for the existence of banks is their ability to lower transaction costs. This argument is based primarily on the existence of market imperfections that enable banks to develop cost effective skills in intermediation. These transaction costs relate to information gathering, structuring, administering and enforcing financial contracts and the range of clearing house and physical funds transfer facilities. A basic reason for the existence of correspondent relationships/access can be found in this transaction cost reduction argument. A bank that is unable to provide a customer with a financial service in a distant location is placing that customer at a cost disadvantage. In the absence of alternatives, the customer is left to make an effort and incurs additional transaction costs as above mentioned. The bank that offers an alternative appoints a corbank to act on its behalf in another country, or the distant location, in order to facilitate the reduction of contracting or transaction costs for the customer. This can be seen as an explanation of the bank size effect finding by Lawrence and Lougee (1970).

4.2.3 Principal-agent Theory

Principal-agent problems are situations in which one party (the principal) relies on another (the agent) to do work or provide services on his or her behalf with a contractual relationship (Nicholas, 1983). When agents' actions cannot be easily monitored and their reports easily verified, the agents have greater scope to pursue their own interest rather than the principal's, since the agent's interests do not necessarily coincide with those of the principal (Jensen and Meckling, 1976, p308). Then, to provide incentives for the agents to behave in the principal's interests, it is necessary to arrange for them to bear some responsibility for the outcomes of their actions and therefore to bear more risk than would otherwise be desirable. Kane (1999) provided a precise definition of Principal-agent problems occurs when one party, the principal, contracts with a second party, the agent, to delegate a task to the agent. The agent chooses to maximize his/her own benefit from the contract at the expense of the principal's benefit. The principal's benefit cannot be completely protected due to the principal's inability to monitor the agent perfectly. This therefore leads to moral-hazard problems.

Gallery, Brown and Gallery (1996) concluded that the interests of the agent (professional manager) and the principal (owner of capital) are incongruous which leads to agency problems. However, the establishment of effective monitoring and incentive structures to ensure that the principal's objectives are achieved could eliminate or reduce the agency problems.

In agency problems and agency cost of corbanking, providing incentives for corbanks such as to bear some responsibilities for the outcomes of their actions are required in order to ensure correspondent banks to behave in the correspondent bank's interest (Jensen and Meckling, 1976) which can be established by contractual relationships (Nicholas, 1983). However, monitoring corbanks via implicit or explicit contracts may become
disadvantageous such as corbanks required to buy account insurance against agent bank closure. The respondent banks may not be sufficiently prudent to prevent moral-hazard/agency problems such as closure of corbanks (Kane, 1999). The corbanking sector within the Australia context is considered as private sector enterprises, therefore, the monitoring and incentive structures that are more effective relying on the presence of three forms of market discipline: (i) Contractual arrangements between profit-seeking shareholders and managers aligning both parties interests; (ii) the threat of takeover; and (iii) the threat of bankruptcy, where managers risk job loss and damage to their reputation in the managerial labour market (Gallery, Brown and Gallery, 1996).

Furthermore, adopting correspondent banking relationships can minimise capital investment overseas. However, this would introduce counterparty risk including moral hazard where agent banks might behave opportunistically according to the principal-agent theory. Agency costs might therefore increase. Nevertheless, most banks largely because of their reputation and some regulations are boundedly rational, complete commercial contracts that specify what they will do in every conceivable circumstance and, thus it reduces agency cost to a certain extent. The two theories principal-agency and transaction cost are closely linked in which principal-agency relationships are a special case of the transaction cost theory. That is agency costs are a part of transaction costs, then Benston and Smith's (1976) minimizing transaction costs give similar results for financial intermediation according to the risk taken and pricing of financial services and commodities.

4.2.4 Relationship Banking

Relationship marketing has a vast literature. Relationship banking is the application of relationship marketing to the banking sector. However, relationship banking is not the
main focus but just a limited part of this research. The relationship corbanking used in
this research mainly means access to corbanking rather a complete meaning of
relationship banking. Therefore, a brief review is conducted by introducing some concept
of relationship banking to be applied into the core of this research. This is a growth area
of banking and emerged from relationship marketing in combination with banking. It also
emerges in parallel to the new organizational from which continue to evolve and to
exploit the business environment (Peck, Payne, Christopher and Clark, 1999).
Relationship banking means that the customer in corbanking perspective, a respondent
bank, is viewed as a client. A relationship bank seeks to satisfy the needs of its clients
(Fraser, Gup and Kolari, 1995). It is unlike a piecemeal services approach on which the
bank acts simply as an order taker—that is, offering services on demand only. Instead, a
long-term, multiple-service relationship is sought that attempts to meet all the client’s
financial needs. While order taking concentrates on completing some immediate task
efficiently, relationship banking intends to employ a combination of good selling and
service to obtain and retain clients. Relationship banking is ideal for selling multiple
products since it is not just able to provide after sales service but also to sell and market
complex and package products in order to keep the bank’s clients. Similar principles are
applied to relationship corbanking, however, the clients are another financial institutions.
The strengths of relationship corbanking include a focus on customer retention and
building customer loyalty, an emphasis upon product benefits that are meaningful to the
customer, long timescales, recognizing that short-term costs may be higher, but so will
long-term profits, an emphasis upon high levels of service which are possibly tailored to
the individual customer, high customer commitment, high customer contact, with each
contact being used to gain information and build the relationship and quality is the
concern of all, and it is the failure to recognize this that creates minor mistakes which lead to major problems (Heffernan, 1996).

4.3 CONCLUSION

This literature review is not just to provide theories and previous studies as background and a starting point for a component-modelling on determinant factors of corbanking and selection criteria of correspondents-of the three components’ core of this research but also to cater for the supports for other two components of this thesis—a case study and empirical surveys. The previous researches were classified into two categories—Immediate Discipline’s literature for direct corbanking research works mostly under the United States banking environment, and Parent Discipline’s literature for indirect corbanking research works mostly in the areas of international banking and banking such as Dunning’s Elclectic theory and relationship banking. The summary of the review is concluded as follows: Corbanking services historically come from the needs of customers for settlements at locations where their bankers were not physically present, particularly overseas. On the grounds of efficiency, commercial banks might not wish to use their foreign branches for all types of businesses and would choose instead to employ correspondents for certain categories of transactions. This is an incomplete rationale for banks in Australia to use international corbanking networks. In the competitive and changing banking scene, many factors that are pushing banks towards using correspondents are among bank size (Lawrence and Lougee, 1970) which is somehow relevant to efficiency, cost savings and mergers, liquidity (Dewald and Dreese, 1970), liquidity and services (Meinster and Mohindru, 1975), economies of scale (the only relevant study is by Gilbert, 1983), and profitability (Knight, 1976). Absence of
Dunning's ownership, location and internalisation advantages means that reputation and knowledge and skill in overseas were not easily obtained. Thus banks are not included to go international via overseas branches. Low transaction costs adjusted to risk are a reason to establish a corbanking network (Benston and Smith, 1976), and transaction cost and agency cost. Corbanks can be monitored by incentives such as responsibilities of actions taken by contracts (Jensen and Meckling, 1976). However, implicit or explicit contracts may be disadvantageous such as corbanks to have account insurance against failure of corbanks leading to corbanks not being strictly controlled (Kane, 1999). The Australian corbanking sector effectively monitored by incentive structures is in the form of market disciplines: Contracts between profit-seeking shareholders and managers aligning both parties interests; threat of takeover; and threat of bankruptcy, where managers risk job loss and damage to their reputation in the managerial labour market (Gallery, Brown and Gallery, 1996). The Principal-agent theory and transaction cost theory are used to explain low agency cost because of reputation pressure on agents to complete agency contracts (Commons, 1934, Coase, 1937, Jensen and Meckling, 1976). Benston and Smith's (1976) argued agency cost and hence transaction cost could be minimized by balancing risk taken and pricing of financial services. Relationship banking stresses long-term, multiple-services and royalty. However, relationship corbanking such as long term business or reciprocal opening accounts will also be applied in this research. The above findings of the survey of the literature form a good theoretical framework for this research.