An empirical study of international correspondent banking in Australia

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CHAPTER SIX:
CASE STUDY: CORRESPONDENT BANKING IN COMMONWEALTH BANK OF AUSTRALIA (CBA)

6.0 INTRODUCTION

This is the first component of the three components' core research. This case study is based on rigorous interviews with a group of CBA’s senior bank staff including Gavin E J Forte, General Manager, CBA’s Institutional Banking; Stephan Symydzuk, Senior Manager, CBA’s Technology and Operations; Robert Buchan, Senior Manager, CBA’s Risk Management; Keith McDougall, Senior Manager, Global Payment Services; Paul McMartin, Assistant Manager Exports, International Trade Processing Centre; and Roland Condell, Manager, CBA’s Business Banking Centre, Toowoomba. The case is presented in two parts. The first part (section 6.1) sets out CBA’s background, history and development, the organisational structure, in particular the institutional banking, rationalisation and current development and performance of CBA. The second part is concentrated on the study of CBA’s correspondent banking in section 6.2. CBA’s definition and management of corbanking will be discussed in paragraph 6.2.1, the organisation of CBA’s corbanking in paragraph 6.2.2, the purchasing management of international corbanking services and reasons for using corbanking in paragraph 6.2.3, selection criteria of CBA’s correspondents and their classification corbanking relationships in paragraph 6.2.4, risk management in sub-section 6.2.5, relationships management in paragraph 6.2.6, strategies of development of CBA’s corbanking business in paragraph 6.2.7, future of CBA’s corbanking in paragraph 6.2.8. The conclusion is in section 6.3.
6.1 BACKGROUND OF THE CBA CASE STUDY

The Commonwealth Bank of Australia is one of the four major banks in Australia. The bank's operations are conducted predominantly in Australia. It has headquartered in Sydney, Australia. The CBA is Australia's largest bank in terms of housing loans and retail deposits and is the second largest in terms of Australian assets, but its global asset is the smallest among the big four. The Bank obtains a large proportion, 68%, of its funds from domestic retail sources (term, demand and non-interest bearing deposits). At June 30, 1997, the Bank had, on a consolidated basis, aggregated approximately A$60 billion, or 22.4% of domestic deposits, with loans outstanding of A$82 billion.

The CBA, together with its subsidiaries, provides a wide range of banking, financial and related services with its staff of approximately 37,000 through a network of 1,612 branches throughout Australia. CBA had Australia's largest branch network. In addition to a number of overseas branches, the bank has a 75% stake in the New-Zealand-based ASB Bank Ltd. During June 1997, CBA announced a joint venture with Bank International Indonesia (BII). CBA operates internationally through its branches in London, New York, Grand Cayman, Singapore, Hong Kong and Tokyo, as well as through subsidiaries in Papua New Guinea, New Zealand, Solomon Islands, and Indonesia. Representative offices in Hanoi, Beijing, Shanghai and Jakarta are also established. CBA has international correspondents in major cities of the world. It also provides international corbanking services to financial institutions onshore and offshore of Australia, in particular Australian dollar services. CBA's principal correspondents are ASB bank in Auckland, Deustsche Bank in Frankfurt, Bca Comle Italiana in Milan, Credit Lyonnais in Paris, Bank of Montreal in Toronto and Union Bank of Switzerland in
Zurich. Domestically, CBA has provided corbanking services to foreign banks and currently is marketing its corbanking services to the regional banks and non-bank financial institutions. Branches, subsidiaries, joint venture in Indonesia, representative offices and international corbanks form world-wide banking network for CBA. Recent merger between the Colonial Ltd with CBA on July 2000 involves increase of the bank size and Chinese regulators have approved to launch a joint-venture between Colonial Ltd and China Life which expansion of insurance business and international financial services in China. Both will have positive impact over CBA's corbanking business.
6.1.1 Organisation Structure and Business of CBA

The organisation structure of CBA's group is exhibited in Figure 6.1:

Figure 6.1 Commonwealth Bank of Australia's Group Structure

Source: CBA's Annual Report 1996. Notes: Boxes drawn by thicker lines are the functional units of CBA. The heads of each and every functional unit represents in the Executive Committee of CBA. International corbanking is under the function of Institution Banking.
CBA provides comprehensive domestic and international banking services, which fulfil basic needs for respondent banks overseas or within the country. The bank’s business mainly comprises:

(1) Personal Banking. It provides a full range of retail banking products and services, including cheque and savings accounts, demand and term deposits, credit card services, personal and housing loans.

(2) CBA Financial Services (CBAFS). It is Manager and distributor of superannuation, investment and life insurance products for individual and commercial customers. In addition, CBAFS manages funds on behalf of wholesale or other institution clients, with investment service managers providing a personalised level of service.

(3) Business Banking. Provides banking services to the Bank’s business customers, other than those with turnover in excess of $75 million.

(4) Institutional Banking. Correspondent Banking is one of the business portfolios of this functional unit. Details of the business will be discussed under paragraph 6.1.4 on Institutional Banking.

(5) Commonwealth Development Bank. It provides finance to small businesses including primary producers.

(6) ASB Bank Limited. Its operations provide personal, business and rural banking services through a New Zealand wide network of 123 branches, as well as selected corporate banking services.

6.1.2 Institutional Banking
Chapter Six

The Institutional Banking (IB), in figure 6.2 a senior functional unit, directly reports to the Managing Director of the CBA. The IB is a highly specialised division of the CBA whose objectives are:

(i) To service the needs of large corporate clients, both within Australia and offshore. These clients include many of Australia's large companies, overseas corporations and government authorities including financial institutions both onshore and offshore; and

(ii) To service the needs of the Bank's retail and business banking networks.

This includes providing products from the money market and services for importers and exporters. The IB comprises of five separate business units: financial markets, banking services (Marketing), corporate finance, risk management, technology and support.

Figure 6.2 Organisation of Institutional Banking

Please see print copy for image

Source: "Which provides high performance for institutional clients," a CBA pamphlet.

6.1.3 Performance of CBA

6.1.3.1 Summary of CBA performance

(1) Underlying Performance. The bank's underlying performance in dollars declined slightly over the period 1991-1994 but improved significantly over the last twenty months. The key drivers of this improvement of performance have been an increase in net interest earnings ($2,844 million in 1994, $3,164 million in 1995 and $3,397 million in 1996) and a stable cost base. However, the level of net interest earnings has been affected
by a combination effect of a number of interacting influences including: growth in interest earning assets; movements in market interest rates; the extent of competition in home lending and commercial lending markets; the level of impaired assets and extent of interest foregone; increases in net interest earning assets; the savings patterns of retail customers; and external influences such as regulatory or budgetary intervention.

(2) Efficiency Ratio. Since 1992, the Bank has improved its efficiency ratio operating expenses to assets, by keeping operating costs stable whilst increasing the asset base and net interest earnings. During the year ended June 30, 1993, a restructuring provision of $188 million was established and was fully utilised through a number of re-engineering programmes in the two years to June 30, 1995 (Phase I). As a result of this reorganisation, staff expenses declined in the period up to June 30, 1995, primarily through a reduction in head count. However, industrial relations problems settled by an enterprise bargaining agreement increased staff expenses in the second half of 1996.

(3) Non-Interest Income. The Bank's Non-Interest Income as shown in the Table 6.1 is from a number of sources. In particular, significant income is generated from fees and commissions. Within the period June 1992 to June 1996, non-interest income has remained relatively and surprisingly stable [at approximately $1.4 billion] for a modern bank.
4) Summary of Financial Information. CBA's overall financial condition has improved markedly since the stormy days of 1992, so those key financial indicators are now back to their pre-recession levels. The trends could be observed from the Table 6.2. 1995/96 profit was up 13.8% from $983 million to $1,119 million. Other analysis results are as follows:

<table>
<thead>
<tr>
<th>TABLE 6.1 NON-INTEREST INCOME 1992-1996($MILLION)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: CBA public shares offer prospectus and annual report dated June 1996</td>
</tr>
</tbody>
</table>

Please see print copy for image
### TABLE 6.2 FIVE-YEAR FINANCIAL SUMMARY (1992-1996)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Assets</th>
<th>Lending Assets</th>
<th>Deposits</th>
<th>Other Public Borrowings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>100,000</td>
<td>50,000</td>
<td>30,000</td>
<td>20,000</td>
</tr>
<tr>
<td>1993</td>
<td>120,000</td>
<td>60,000</td>
<td>40,000</td>
<td>30,000</td>
</tr>
<tr>
<td>1994</td>
<td>140,000</td>
<td>70,000</td>
<td>50,000</td>
<td>40,000</td>
</tr>
<tr>
<td>1995</td>
<td>160,000</td>
<td>80,000</td>
<td>60,000</td>
<td>50,000</td>
</tr>
<tr>
<td>1996</td>
<td>180,000</td>
<td>90,000</td>
<td>70,000</td>
<td>60,000</td>
</tr>
</tbody>
</table>

Sources: CBA Update May 1996 and Annual Report 1996
Notes: (1) includes Loans, Advances, Lease Financing and Bills Discounted and Bank Acceptances,(2) includes amortisation of goodwill and charge for bad and doubtful debt.

(a) Balance sheet and profit and loss items: referring to Table 6.2, balance items-total assets, lending assets (decreased one year), deposits and other public borrowings, and
profit and loss items increased throughout the five year period indicating strong performance and a solid financial position.

(b) Share performance: earning per share, dividends per share, and share prices sustained growth for the five-year period. The earning per share as at June 30 1996 was 115.5 cents per share has more than doubled since 1992.

(c) Performance Ratios: return on equity (ROE) before abnormal items and Return on assets (ROA) was strongly increasing for the five-year period-1992 to 1996. Capital adequacy improved from 9.84% in 1992 to 11.45% on June 30 1996. Increasing Tier 1 capital largely contributed to this improvement. This indicates that CBA under utilised its credit standing comparing with the minimum capital adequacy requirement 8% set by the Bank for International Settlements.

(d) Productivity: income generated per staff was improving throughout the five year period from $101,632 in 1992 to $135,739 in 1996. The staff expense to income ratio reduced from 38.4% in 1993 to 32.3% in 1996. Sustained improvement on cost cutting rendered within the five-year period via total operating expenses to total operating income ratio 67.7% in 1992 to 60.6% in 1996.

(5) Credit Rating. Referring to Table 6.3, three-credit agencies assessment of CBA’s short-term debts remained unchanged but one down grade for CBA’s long-term debts or counterparty risk. A “B” grade from Moody’s bank financial strength indicates that CBA has valuable and defensible business franchises, good financial fundamentals, and an attractive and stable operating environment. CBA’s stand-alone financial profile remains sound and compares favourably to its peers, both in the domestic and international context.
TABLE 6.3 CREDIT RATING OF CBA (JUNE 1996)

| Note: Moody's Financial Strength Rating (Moody's Credit Opinions-Financial Institutions, June 96) |
| Source: News Release Standard & Poor's (June 12 1996), Moody's Investor (June 12 1996) and IBCA (June 12 1996). Moody's bank financial strength for CBA is "B". |

6.2 INTERNATIONAL CORRESPONDENT BANKING OF CBA

CBA’s international business, in particular international corbanking business, despite the requirement of 8% capital adequacy requirement for lending business is relatively behind other Australian majors which could be reflected by its underdeveloped overseas network. After the privatisation of the bank, CBA needs to improve its competitiveness and efficiency in order to increase its profitability for survival in Australian banking markets, otherwise there is a threat that CBA may be taken over by, or merged with, other Australian Banks in line with the current trend to create an international mega bank. CBA’s corbanking business has been slack for a long time and it is the time to improve its profitability in order to contribute to the development of CBA, in particular the expansion of the international business of CBA. The bank has started to consider international correspondent banking as one of its international expansion strategies. CBA places itself as a corbanking services and products provider as well as an user. However, it markets actively its corbanking business to onshore and offshore financial institutions on the one hand, and it strongly requires the use corbanking services provided by domestic and cross border financial institutions on the other. Currently, CBA’s organisational structure for corbanking business is under overhaul.
6.2.1 Definition and Providing Management of Corbanking

CBA sees the corbanking business, from both the supplier and user point of view, as "total relationship management", involving the establishment of long-term and continuous relationships between banks. Corbanking therefore involves providing products and services to satisfy client banks' needs and even tailor-make services and products to their needs. This "total relationships management" is applied to some banker clients who intend to establish long-term relationship. However, some banks want to have only limited relationships or one off dealing which do not have any further business potential to establish total relationships. The range of services and products are clearing and payment services - Vostro/Nostro accounts (Vostro in AUD and USD) and cashletter, trade finance, treasury services involving credit or non-credit relationships and financial market activities, international syndicated lending, custodian and advisory services. Tailor-made services and packages would also be supplied depending on the level of relationships and requisition. Trade related services, clearing services, treasury services including issuing debt securities, and international syndicated loans were worth 30%, 25%, 30%, and 10% of the total corbanking revenue respectively. Other services - custodian, advisory and tailor-made services were worth about 5%. CBA planned to expand its range of products and services such as fund management and foreign exchange. CBA had average Vostro account balances - A$120 millions and US$40 million at the forth quarter 1996. Although it is debatable whether Vostro balances are a good indicator to determine activities of corbanking, it remains as a relevant indicator for corbanking activities by looking at its average over a period in practice. It is not easy to maintain a minimum level of balances for many reasons: banker clients are very active but have low credit standing.

Looking at the trend of the Vostro balances for the past 10 years, the balances in CBA
were increasing, the main reasons are that many CBA's clients are from developing countries: China, Vietnam, Indonesia, Thailand and Philippines which are very active due to their economic development. They have large funding needs and require to take costs of funds and credit standing into account for transactions via Vostro accounts which virtually force them to maintain large amount of funds in their Vostro accounts. Fees for services are always issues in corbanking. In CBA's opinion, it preferred to charge fees with minimal compensating balance for corbanking services. Currently, CBA charges fees for most corbanking services. However, fees at concession rates are granted to clients with large business volume in value as well as minimum Vostro compensating balances. According to classification of banker clients, financial institutions overseas, non-bank financial institutions in Australia, foreign banks in Australia and regional banks were 80%, 14%, 5% and 1% within CBA's corbank portfolio respectively. Moreover, CBA targets about 90 key clients within the Asian region in particular Thailand, Malaysia and Philippines. Europe, Northern America and Pacific regions were second, third and forth priority target markets respectively. CBA previously focused on the domestic market and was slow to develop it global corbanking business including its Australian dollars, or operations business, which are the strength of CBA. CBA has the potential to be the largest Australian dollar clearer although having other majors as its competitors. Furthermore, the recent development of Australian banking scene, Australian financial institutions in particular, regional banks and some non-bank financial institutions (NBFIs) because of customer's needs, started to look at their international and Australian network. Both types of financial institutions required a good international network to handle their international business and domestic business; thus, some regional banks and NBFIs outsourced their international corbanking businesses to other banks such as American
banks in Australia. This is an rosy opportunity for CBA to supply its corbanking services to regional banks and NBFIIs but CBA needs to improve its international services and network prior to market her corbanking services. CBA considers its corbanking functions as a profit centre. The revenue of corbanking business was recognised by creating a shadow accounting system for some functions. For example, payment clearing and LC transaction were sub-contracted to the Global payment and International trade processing services centres within the bank which charged those services at costs, thus the income generated could be consolidated and allocated to the Banking Services/ International Business Group as revenues of corbanking function.

6.2.2 Organisational Structure of CBA International Corbanking
There is no specific departmental structure charged with all the functions of the International Correspondent Banking. The principal functions of Corbanking are maintained by the international business group within the Banking Services of the Institutional Banking Division and other groups scattered within the Organisational Structures of the CBA. Corbanking is recognised as a banking function, which was established since 1982, that is fifteen years ago. Prior to the corbanking function being recognised, it was a part of processing transactions such as a payment and documentary credits process. At the third quarter of 1996, approximately fourteen corbanking full time staff consisted of seven relationship managers, five analysts and two office staff.
The correspondent banking (international) in Figure 6.3 provides the following functions for Asia, Europe and Americas in paragraph 6.2.2.1 to 6.2.2.4:

6.2.2.1 Marketing and establishing correspondent banking relationships.

Marketers of Corbanking business are teamed under Correspondent Banking for International Bankers and Australian Balance Sheet for Domestic bankers, including local banks and non-bank financial institutions and foreign banks in Australia. The third arm of the Banking services is Trade Finance which also involved in operations and marketing of trade finance transaction banking services.

The Groups for banker clients within the Banking Services currently consist of about 20 staff who are to market the CBA services and products such as Vostro accounts (mainly AUD and USD), cashletters, syndicated lending, financial market products, trade finance, futures clearing, custodial services and so on to financial institutions world-wide, and to establish business relationships with those financial institutional clients internationally and domestically.
Marketing and establishing correspondent banking relationships are the core functions of correspondent banking. Prior to the establishment of a different degree of banker's relationship, marketers need to have credit risk reports of the banker client and credit risk reports for the deals or relationships which are to be provided by the risk management unit. After the relationships have been established, the transactions will be carried out by various operational units within the CBA, such as treasury products operated by Financial Markets, international payments by Global Payment Services in Sydney, international trade finance settlements by International Trade Processing Centres, and local payments by payment processing centres.

6.2.2.2 Risk management of banker clients. The function of risk analysis is carried by the unit of risk management which is a unit with the same level as the Banking Services under Institutional Banking, however, the unit reports directly to the Group Credit Policy and Control. The risk management for financial institutions within the risk management unit is to perform risk evaluation; risk measurement, approval and ongoing risk management for correspondent/respondent financial institutions onshore and offshore. Three teams analyse risk and provide risk management services to three territories: Asia, Domestic (Regional Banks and Financial Institutions), and Europe and America respectively.

6.2.2.3 Operations of correspondent banking products and services.

(a) Trade Finance services are provided by each and every CBA International Trade Processing Centre (ITPC) in major capital cities: Sydney, Melbourne (for Hobart), Brisbane, Adelaide (for Darwin) and Perth. Services and products for international trade financing include documentary credit facilities, AUD and foreign currency trade advances and documentary collection facilities for importers and AUD overdraft, AUD commercial
bills, foreign bill negotiation facility, trade advances, USD overdraft, documentary credit confirmation/without recourse facilities for exporters. The processing centres also provide computer-initiated documentary credit service (CIDOS) which allow importers the ability to electronically initiate, deliver and record all documentary credit requirements from the convenience of their own office.

(b) International Payment Services are provided by Global Payment Services (GPS) in Sydney. The CBA has a centralised payment system where any crossborder settlement or payment entering or leaving Australia must be transmitted through the Sydney Global Payment Services at Liverpool and Castlereagh Street, Sydney CBD. Principal products and services provided by the Global Payment Services are payments/settlement in AUD and major currencies, enquiries and investigation relating to settlements and payments, and international clearing for payment of paper items such as traveller cheques and collections. SWIFT and tested-telex are most commonly used to correspond with banker clients.

6.2.2.4 Corbanking services via collaboration of banking services and its external units. Many corbanking services and products are provided via units external to Banking Units for technical expertise but the Banking Services unit takes charge of relationships management. For examples - treasury service - foreign exchange, securities and derivatives trading to banker customers and specialist services are provided by the Financial Markets unit within Institutional Banking. Asset and liability products, project finance, structured and asset finance transactions are provided by the Corporate Finance unit which is also within Institutional Banking (in Figure 6.2). Nominee and Custodian Services such as safe custody, settlements and income collection are provided by CBA
Financial Services operating by CBA Nominees Limited external to Institutional Banking (in Figure 6.1).

6.2.3 Purchasing Management and Reasons of Establishment for CBA Corbanking Relationships

CBA views corbanking as a way to provide efficient international services to customers as CBA is not physically present in overseas locations. Currently, CBA maintains a huge corbanking network; there are in excess of 1,600 individual arrangements with corbanks in over 175 countries. However, CBA still faces the situation that no bank can open offices in each and every location in the globe. CBA’s ways to manage her purchasing corbanking services and reasons or determinant factors of corbanking relationships will be discussed as follows:

6.2.3.1 Purchasing Management. CBA had more than 1600 corbanks, however, it concentrated to buy corbanking services from about 15 key suppliers such as Hongkong Bank (which has a substantial presence in Asia and the United Kingdom via its subsidiary the Midland Bank) and Bank of New York (which is the United States dollar clearing agent since CBA has withdrawn from CHIPS memberships from 1996) in order to support its international banking business. Thus it encompasses a range of international products, including instruments to support Australian exporters and importers; overseas money transfers; travellers’ cheques; foreign currency accounts; business migration; and corbanking relationships. The Bank is paying particular attention to the development of its capabilities in the Asia/Pacific region. The most important corbanking products and services used by CBA according to priority of importance are clearing, treasure, trade-related, international syndicate loans services, and then followed by less important services like custodian and advisory services. In terms of selection right suppliers, CBA
had formal procedures to choose suppliers according to established CBA policies, which review and measure previous transaction records of potential and existing corbanks. CBA had more than one corbank in foreign countries and cities and at least one corbank in major financial centres in the world. Currently, CBA is in the process of rationalising its corbanking system by looking at reduction and concentration on fewer suppliers, and strategic alliance arrangement in order to improve its international banking abilities. Furthermore, the main reason for this rationalisation is to improve efficiency, reduce costs and simpler currency funding and reconciliation, followed by less important reasons - lower price, easier communication, better use of technology and improve customer services compared with the most important reasons of all banks - lower price ($t=-5.69$) and improvement in customer services ($t=-5.36$) (Table 3.8.1 in Appendix 4).

6.2.3.2 Determinant Factors of Corbanking Relationships. For many banks, corbanking arrangements are an alternative of international banking investment for today’s banking environment. They set it as a relatively cheap, easy, and flexible way to enter and operate in foreign markets. Moreover, it has become more favourable recently because of the problems with required asset growth and capital ratios (8% a rule of the capital adequacy ratio), inadequate yields and the credit risk (imbalance between credit risk and compensating yields) involved in international banking. Another important point is that correspondent banking is not threatening to local banks or the host country government, but rather is viewed as a source of opportunities. Indeed, it may be the only type of involvement a foreign government will permit. CBA developed its international corbanking based on the following: A location where CBA not physically present, customer driven and to complete CBA’s international network, followed by cost saving, competitiveness and improve efficiency; these are the main reasons for CBA to use
corbanking services as a means to support its international business. The worldwide presence of the CBA was considered underdeveloped in contrast with other majors, therefore, CBA needs a corbanking network to supplement and thus complete its international network. Many customers of CBA are top 1000 multinational companies in Australia, which need to have cross-border banking services. Overseas corbanks of CBA may also be important sources of referrals for business to be carried out in the country of the corbanks. Establishing corbanks was customer driven.

Timely and quality international services are the two major contributing factors for improving efficiency and competitiveness, and saving costs for respondent banks which can be achieve via corbanking services. Furthermore, CBA also considered the additional advantages of using corbanking services - needs, gaining access to local market, increasing profitability and providing liquidity. CBA chooses corbanking channels as a way to distribute its international banking services, which is consistent with corbanking literature. The initial impetus for having correspondent banking is customer driven (Sabi, 1988). Lawrence and Lougee's (1970) determinants also apply to CBA, including Bank Size and geographical reasons. Gilbert (1983) and Knight (1976) concluded cheaper fees charged by correspondents because of the economies of scale, also apply to CBA.

Dunning's Eclectic Theory (Dunning, 1979) also explains helps why CBA buys or sells services from/to other banks through corbanking relationships, rather than investing in the market. This is because CBA lacks competitive advantages in the three specific areas: ownership advantages, internalisation and location. A list of factors specific to a particular place, such as labour and ownership advantages, liquidity issues (Dewald and Dreese, 1970, and Meinster and Modindru, 1975), Transaction costs (Coase, 1937 and
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Williamson, 1979) explained why CBA will not internalize whenever suppliers of corbanking services are competitive in some transactions.

(a) CBA Funding and Liquidity. CBA’s total funding is A$84,444 million as at June 1996. This consisted of domestic funding (A$77,743 million) and offshore funding (A$6,701 million) requirements. The domestic funding was 64.2% funded by retail deposits, 12.8% by bank acceptances, 10% by semi-professional deposits, 5.8% by bond issues, 3.5% by loan capital and so on. The CBA offshore funding was 71.7% mainly funded by foreign currency deposits and interbank, 19.6% by commercial paper, 7% by debt issues, and 1.6% by bank acceptance and others. With no offshore retail foreign currency base, the CBA is principally reliant for offshore funding on money and capital market sources. CBA had followed a deliberate strategy of diversifying its sources of foreign currency into a range of markets in order to avoid over-reliance on any one market or maturity term. Principal sources currently available to the bank to meet its maturing foreign currency debt are as follows: Inter-bank lines with banks world-wide; US Commercial paper program; Multi-currency Euro-commercial paper and certificates of deposit programme; Euro medium term note programme; International bond and loan markets; Corporate/customer foreign currency deposits offshore and in Australia; Certificates of deposit issued through the Bank’s London Branch in Sterling, US dollars and Australian dollars. The Bank was able to generate foreign currency funding through the foreign exchange market by utilising its domestic Australian dollar deposit base. To support its foreign currency liquidity base, the Bank conducts money market books (principally inter-bank: among branches or branches and Head Office of CBA or CBA and its corbanks) in substantially all of its licensed offshore branches through the Sydney
head office. The offshore funding activities are evidence for using corbanking services for CBA liquidity.

6.2.4 Selection Criteria of CBA Corbanks and Classification of Corbanking Relationships

Since CBA strategically used corbanking to complete its international network, the next step was how CBA from microeconomic point of view selected its corbanks and classified corbanking relationships.

6.2.4.1 Selection Criteria of CBA Corbanks

Selecting a corbank is no easy task, but it is important because of the potential long-term relationship. Also when there is a change of relationships such as from non-credit to credit business relationships, further consideration has to be given not just to the credit standing of the corbanks (by having an updated credit reports from Risk Management, but also other commercial factors such as the range of services provided and the pricing must also be taken into account). For selecting of new corbanks, CBA’s corbankers usually refer to banking directories such as the Bankers Almanac, Thomson Bank Directory and Polk World Bank Directory for initial corbank selections. Risk Managers are also asked to analyse the chosen potential corbanks. Only corbanks rated at least at the threshold grade of risk depending on the nature of the business such as credit or non-credit banking services and the amount involved. Then the potential corbanks should be listed for further consideration in the selection process.

Formal banking presence, range of services provided, linkage to communication, operating capabilities, financial strength; effective and efficient product delivery and risk rating and followed by competitive pricing, broad domestic and global branch network,
technological level, continuous reliability supply and compatibility of services with CBA were CBA's most important criteria affecting the selection decision of correspondents.

Formal banking presence does not only imply physically presence, these days communication technologies make the physically presence of corbanks less important, but it is necessary for corbanks to have a banking licence at certain locations. Communication abilities and technological levels such as linkage with SWIFT were vital for international banking services because of cross border distance. Range of services and operating capabilities of corbanks are required by CBA. CBA does not require the whole range of products and services numerous correspondents are offering, since demand depend on the core business that CBA is active as well as niches. It is crucial to identify corbanks that could provide the services that serve CBA's needs. CBA may have more than one corbank in overseas cities since some banks cannot provide specialist services needed by CBA. Large overseas corbanks always have excellent local networks but they may not have strong specialist services such as merchant banking expertise provided by smaller overseas corbanks. CBA may use the same corbank in different locations within a country or city or in different countries depending on the needs and relationships with CBA.

SWIFT delivery of services was the basic requirement of global corbanking services since corbanking services usually have to be completed within a short time frame. Thus effective and efficient product delivery and effective account officers are elements in the running of good corbanking. Financial strength and risk rating are relevant to counterparty risk, which CBA always is concerned with.

The choice and acceptable costs and thus prices for services provided by the corbanks with minimisation of operational errors, speed in responding to problems and resolving
them efficiently, and flexibility and speed in responding to changes in customer’s requirements are the most important element for CBA’s selection decision. Continuous reliability of supply and compatibility of services with CBA are to ensure that corbanking services delivered accurately and timely.

### 6.2.4.2 Classification of CBA Corbank Relationships

CBA classified its current international banking correspondent relationships into three tiers according to factors: business potential, return of equity or asset, profitability, responsiveness and quality of services:

* **Tier One correspondents**: The best grade of all the three tiers. This tier of correspondents have very active business with CBA including trade finance services, clearing services such as *Vostro* and *Nostro* accounts, syndication loans and other standard international banking services which provide a high amount of stable revenue to CBA. In addition, they have excellent credit standing and grant large credit limits to CBA. Formal contractual relationships and great business potential are involved in this tier of banker clients.

* **Tier Two correspondents**: This tier of correspondents has active business with CBA mainly including trade finance services, clearing services, syndication loans and other standard international banking services which generate average and stable revenues to CBA. In addition, they have good credit standings and grant credit limits of facilities to CBA. Formal contractual relationships and business potential are involved in this tier of banker clients.

* **Tier Three correspondents**: This tier of correspondents have less active business association with CBA they mainly include trade finance, clearing and standard international banking services which provide acceptable levels (revised from time to time)
of revenues to CBA. In addition, they have satisfactory credit standings and grant low credit limits of facilities to CBA. Some business potential is involved.

Approximately 250 correspondents are categorised under tier one and two out of the total number of correspondents - nearly one thousand currently. Correspondents beyond the three tiers usually are those inactive correspondents or correspondents with one-off business, with little or no business potential. Benefits gained from correspondents classified beyond the three tier groups are not sufficient to cover the high cost of managing them, therefore, it is uneconomical to maintain this group of correspondents.

6.2.5 Risk Management to Corbanking Services

The objective of risk management is to ultimately limit volatility in the risk, in particular credit risk, faced by CBA and to ensure a risk level within tolerances agreed by the bank’s board balancing between risk and return. CBA considers that risk management is about managing risk, not rejecting it. Risk management to corbanking services includes various risks relevant to corbanking products and parties involved, nevertheless, counterparty risk is the most important one. Although sometimes the ultimate decision may well be to let the opportunity pass, the primary aim is to try and take the risk and fashion it in such a way that it is acceptable. By working within the boundaries set by the most senior levels in the bank, the risk can sometimes be minimised by changing the parameters of the deal, that is, reducing the terms or by imposing covenants on the credit, or the borrower.

The general approach to risk management by CBA will be discussed with reference to individual credit granting with emphasis on a portfolio approach within the framework of CBA’s credit architecture (which consists of people, tools and credit procedures and policies) and credit culture (which is ways of managing credit risk). The Credit rating of
correspondent banks or client banks and risk management with client bank businesses will also be discussed within the paradigm of CBA’s credit risk management approaches.

The main risk classes that particularly affect banks include: credit risk, country risk, market risk, liquidity risk, documentation risk, and operational and settlement risk. All of these risks are important, however, poor credit risk management will remain the most common cause of banks losing money. There are no new risks in banking, it’s just that some of these risks have become more complex. Nevertheless, the common sense banking rule for controlling risks of client banks still applies is “understand, measure and manage”.

6.2.5.1 Risk Management Organisation and Independence

Although the risk management function of Institutional Banking is worked under the Institutional Banking, it is directly reporting to Group Credit Policy and Control of Financial and Risk Management within the board. The risk management therefore has special power to veto the decision made by marketing staff of correspondent banking on the ground of credit risk.

Group Credit Policy and Control reports directly to an executive director and not up through business unit heads where key result targets may conflict. Therefore separate risk management functions in the Institutional Banking area further separate the marketers from the credit controllers within the business units. The aim for senior management of CBA is to keep both teams: the marketers - expanding business, and the risk managers - reducing loss of money, evenly balanced to produce continuing asset growth opportunities with appropriate risk, and attracting an optimal reward. This independence has become a fundamental principle of effective risk management in CBA.
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The analysis of credit standings of client banks is the responsibility of the risk management which is further classified into three units according to geographical areas: Asia Pacific, Europe and America, and local and regional banks. There are also groupings for analysing credit standing of corporations within the risk management of institutional banking. The credit structure within CBA for both client banks and corporations /institutions is similar with different emphases in operational analysis.

6.2.5.2 Technical Structure of Risk (Credit) Assessment

Risk assessment in corbanking includes counterparty risk, product risk, country risk, settlement risk and Credit risk. The most specific problem for corbanking services is counterparty risk, which consists mainly of credit risk. The CBA’s technical structure is used to assess all risk for all transactions. A simple credit technical structure of CBA consists of “Credit Architecture” and “Credit Culture” where the credit culture binds together the credit architecture or the whole credit structure which provides the credit or risk management organisation with a shared credit language; a shared conceptual credit framework; and a shared understanding of people responsibilities, accountabilities and roles. Furthermore, CBA’s management uses credit auditing in order to ensure that the credits being approved by management are complying with the credit standards. Measures used to also ensure the integrity and effectiveness of internal credit auditors including the audit reports and its findings must be submitted to the Board; the measurement used by the credit auditor in assessing the portfolio must be clearly understood; the status of credit auditor must be well respected within the bank; and the audit function must be continuous and regular (Buchan, 1996).

CBA’s credit architecture comprises:

(a) People: all levels of bank staff involved in credit risk management activities;
(b) Tools: credit risk rating system (which is used to represent the risk of loss from credit exposures involving the probability of default of a credit and the likely loss given default); risk migration tracking system (a tabling system, which is used to assess the changes in the quantum of risk by tracking the changes in the risk profile via measuring the risk inherent in a portfolio within a rating system); and risk adjusted profitability model (which is used to assess the risk/return for the quantum risk). The first system is used to measure risk, the second system is used to monitor risk and the third tool is to measure the risk being taken by CBA. All types of risks including credit risk, market risk, country risk, payment risk and any risks that banks take in the business of banking must be factored in for establishing an appropriate return. That is, the banking profit is a risk-adjusted profit;

(c) Credit procedures and policies. Credit culture influences risk manager's behaviour. CBA uses a values driven credit culture. Values are integrity, balance and candour promoted by CBA's senior management. Long-term consistent profit performance is the goal of an appropriate credit culture.

6.2.5.3 Sources Supporting Risk Assessment

CBA's main sources for assessment of counterparty risk are according to priority: an in-house credit team at head office level, followed by rating agencies - Moody, S&P and IBCA, other banks and banker clients, and less important regulators, periodicals/publications, and other clients.

6.2.5.4 Factors of Counterparty Risk

CBA stresses asset quality, liquidity and supervision of regulator/protection as most important factors for counterparty risk. It also considers performance, funding, capitalisation, market risk, external and political support as contributing factors for
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counterparty risk. Settlement risk is part of counterparty risk, however, inherent risk of payment systems of some countries play an important role over settlement risk.

6.2.5.5 Credit Rating and Corbank Global Credit Limit

CBA's counterparties range from small banks to the world's largest and best banks in small and/or developing countries to the largest and wealthiest countries. Whilst realistically banks rarely default, when they do, they make a large splash in terms of amounts and effects on of number of banks and countries, as in the Baring's case. Bank counterparty credit risk is a field requiring just the same or a greater amount of care to detail as commercial and corporate lending. The risk of default of banks generally may be less, but the amounts at risk are usually larger. CBA considers a bank rated say Aa under Moody's system to have the same risk of default as that of a corporate rated Aa. Furthermore, CBA's basic principles of credit granting for counterparty banks are the same as the basic laws of lending, that is the five C's of lending: Character, Capacity, Conditions, Collateral and Capital. In CBA, the risk is analysed in a Two-Stage Process: That is Country risk, which is analysed by country managers presented in country reports, and the credit risk is analysed by risk manager.

(1) Country Risk and Report. The reports provided by CBA's country risk economists focus primarily on the possibility of the three prime risks of country default, in addition to the normal listing about countries such as political risks, sovereign risk and so on:

(a) Chronically deficient foreign exchange earnings: usually due to some ongoing vulnerability in the country's pattern of wealth generation;

(b) Short term crisis in foreign exchange availability: caused by a sudden cash flow interruption to foreign exchange earnings; and
(c) An unwillingness to repay: which would usually arising from a radical change in
government.

The conclusions of the economists are, that where available and appropriate, cross-
reference should be made to external credit agencies such as Moody and S&P opinions.
Also the CBA’s corporate memory is used and previous losses or experiences in that
country are considered. The CBA’s economist’s conclusion is then measured by way of a
country rating, similar to the probability of default rating or the client quality
classification as discussed in the credit risk rating system. Issues relevant to country
reports are considered vital to CBA are:

i) In-country limit size: the country limit size must also be taken into consideration
for those countries with the same credit rating United States and Norway which have a
triple A long term credit rating. Country limit size for countries sharing similar
probabilities of default are differentiated by various hurdles or credit underwriting
standards that focus primarily on the country’s net debt obligations, and its foreign
exchange earning capacity, by the way of its GDP and its level of exports. Therefore the
United States should have a much larger country limit than Norway. In addition, CBA’s
strategic focus on particular countries or regions such as Indonesia, China and Vietnam
for marketing and asset diversification purposes must also be taken into consideration for
granting country limit.

ii) In-Country Banking Systems, after the acceptable level of country risk has been
defined and after the five C’s relating to the particular institution have been considered,
the structure and type of banking system operating within the country must then be
understood. Not only must the central bank and the other regulator’s, rules and conditions
be clearly understood, it is critical to know whether those rules are enforced and adhered
to. Therefore, the punishment for breaching regulations and the extent of inspection and control exercised by the regulators must be clear. It is insufficient having stringent laws but little or no enforcement such as in the Peoples Republic of China.

iii) Local knowledge, the access to local knowledge can only be obtained by the risk manager travelling to and maintaining contacts in the countries he is responsible for and by his organisation having a network of branches and representative offices that can supply him with information such as CBA in Asia has either a branch or representative office in Jakarta, Hanoi, Hong Kong, Beijing, Shanghai and Singapore. These offices provide the country risk manager in Head Office with invaluable sources of data and opinion that play an integral part in managing CBA country risk exposures.

(2) Client Bank Credit Rating. CBA’s Analysis of international client bank credit rating is also within the framework of CBA’s credit culture and credit architecture. It also refers to the country reports produced by the country economists and local knowledge produced by the country risk manager with cross section references to credit agency reports. The detailed of analysis of client banks depends on the sizes of banks as well as the country of the incorporated banks. Generally, less analysis of big banks in the G7 or developed countries is performed compared with those client banks in developing countries such as Asian countries (except Japan) and Latin America. The credit rating of banks from OECD countries are heavily based on the reports which are produced by credit agencies like Moody’s, Standard and Poor’s, and Thomson Risk Management.

For those banks that need to have more detailed analysis, in addition to the normal financial analysis of the client bank financial statements and cross reference to credit agencies such as Moody’s, S&P, Economic Intelligence Unit of the Economists are
needed since reports from those credit agencies may not be accurate enough. The following items are crucial for bank credit rating analysis:

(a) Understanding the banking system of the countries. How do the client banks fit into the banking system? Whether the bank is a rural or large bank, and a small or large bank. Strengths and weaknesses of the bank in terms of businesses or finance. The influential characteristics of the bank to the banking system. The strength of the bank could be estimated by its state of importance in the banking system. Furthermore, regulations and prudential guideline of the banking systems and enforcement abilities of the central bank in the particular country are also vital for the decision of the bank credit rating, which sometimes need to depend on the subjective judgement of the risk manager of CBA.

(b) Liquidity of the client bank. Banks rarely actually go bankrupt; they simply run out of funding. Ensuring that the deposit base is secured and can survive short-term shocks is critical for survival: that is, maintaining liquidity is an important condition for CBA to grant credit to its client banks. Sources of information are not just from the book of the client bank but also from the markets.

(c) Financial resources, quality and stability. Banks that are financially sound are important but it should not be over emphasised. Total asset size of banks is considered an important measure of acceptability from a fiduciary and business standpoint but the impact of the October 1987 crash has resulted in bankers looking more diligently at the asset quality and capital adequacy of their correspondents.

(d) Quality of bank management. This is a major driving force in running the bank. It is rather subjective. Integrity, Capability/Competency, stability, vision, support, and risk attitude towards businesses and so on could reflect the quality of the bank management.
(e) Country risk, transfer risk and political risk. The last two risks are risks related to country risk, which has been considered in the paragraph on the country report.

In addition, (f) Behaving like a lemming. Often banks follow the fashion of the times such entering LDC lending, Property lending or Derivative markets without really identifying why there are advantages in these markets. Disaster often results.

(g) Forgetting diversification to reduce risk. Over-concentration of risks can lead to disaster. Diversification is also too often forgotten. A well-diversified portfolio should be held (Bishop, Crapp, Faff and Twite, 1993). CBA, a large bank is likely to have more opportunities to diversify across geographical regions, business portfolios and so on. Asset diversification and the resulting financial returns to scale are found to be a significant part of the total scale efficiency picture (McAllister and McManus, 1993).

(h) Lack of understanding of new markets. When banks step into new markets they open up a whole new range of risks. Insufficient understanding of these risks could lead to disaster. Analyses of the client banks by site visits is seen as an effective way to obtain new information and confirm available information. In order to have quality information, contact is also made with bankers such as at Citibank, financiers, accountants and solicitors in the countries of investigation. The client bank credit rating is also based on the probability of default of a credit in which a client bank quality classification is expressed in an, A through H scale; A is the best rating but H the threshold credit rating in which the security classification is also taken into account. Security classification under the likely loss given default is expressed in an A through F scale where A rated credit has over 100% security but F is an unsecured rating. All the credit building blocks: people, tools and credit procedures and policies are equally applied to client bank credit rating analysis including underwriting standards, portfolio approach, country studies and
auditing. It is CBA’s common practice for country studies and auditing to be reviewed annually. Therefore, the client banks (either correspondent banks or respondent banks) credit rating needs to be reviewed annually under normal circumstances. The system for the grading of client bank position are to be consistently checked and re-checked.

The setting up of client bank crediting ratings is basically related to CBA’s having started to set up business links with the client banks. The most common one is to form a corbanking relationship, joint venture or partnerships in the businesses with credit granting or clean basis. The principles of CBA management are: the lesser the risk, the better the credit rating, and the larger the threshold credit limits. The client banks must reach a minimum or threshold credit rating in order for the marketers of CBA to have business association with corbanks or counterparty banks in terms of clean credit granting or secured credit granting. Therefore, CBA’s corbanking marketers must have credit clearance of potential corbanks from the CBA’s risk management unit prior to proceeding the business links. If the corbank has reached the threshold credit rating, it could have a credit limit granted by CBA depending on its needs and credit rating. A less risky corbank will have a larger threshold limit. If the corbank needs a limit larger than its threshold limit, then the CBA board approval is necessary. In the case where the line limit is larger than A$100 million, the board’s approval is also required.

(3) Corbank Global Credit Limit. The global credit limits of CBA’s corbanks are controlled by the Head Office in Sydney. For instance, Credit limits for each and every Standard Chartered Bank in London, Sydney, Singapore, New York, Tokyo and other financial centres all fall under the global credit limit of Standard Chartered bank world-wide with the record keeping and monitoring in Sydney. Any branch that makes use of the credit facilities granted by CBA will be counted under the overall or global limit of
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Standard Chartered. However, CBA's overseas branches do have a certain degree of autonomy to grant credit to certain banker clients on an ad hoc or one-off basis. Permanent relationships with granting of credit facilities must have the Sydney Head Office approval by going through the normal approval procedures including credit investigation.

6.2.5.6 The Crisis Management Plan

In a situation where disaster strikes such as the Baring Brothers Case, too often when the worst case scenario is realised, the situation is made worse by staff who don't know what to do or are not sufficiently organised. In these cases, it is critical to act quickly. Whilst every situation will be unique, the areas needing attention in a bank failure are generally similar. The crisis management plan of CBA consists of the following four items:

(a) Co-ordination: a person must be appointed as head of the crisis management team. His task is to ensure everyone that who should know the problem does know the problem. This role acts as the central point for the management of the situation;

(b) Payment Systems: this entails quickly establishing the items and numbers that are at risk such as what payments are due to be made;

(c) Reporting: this position is responsible for updating the most senior levels of CBA with the details of the problem, the immediate action being taken and providing recommendations for future action. This area will also handle the issuing of directives to other general areas of the bank indicating what can and cannot be done and lastly

(d) Analysis: this role covers understanding what caused the problem, the chances that other institutions are likely to be affected and what can be done to further protect CBA's position.
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The existence of the plan and adherence to it played a large part in the CBA's suffering no loss as a result of the Baring Brothers collapse.

6.2.6 CBA Corbanking Relationship Management

Relationship management involves management of long-term corbanking accounts. CBA as a correspondent classifies its banker clients into three tiers: one to three from the best to satisfactory, similar to CBA as a respondent in the paragraph 6.2.4(ii). Most important factors for grading the relationships are revenue and profit generating, and low cost for CBA, followed by risk rating, commitment on business, responsiveness and quality of services. The relationships are reviewed periodically depending on the level of activities, value of the transactions and relationships. On average, all clients are reviewed quarterly. CBA considers the benefits for long-term relationships as price stability, enhanced marketing efficiency, sharing information and good rapport with clients. All corbanking relationships with CBA are in the form of formal written contracts. The International Business group has restricted authority to approve smaller values and short term or contingent credit limits. Normal credit needs to be approved by the risk management function under Group Credit Policy and Control. The country limit equals the aggregate limits of banks in a particular country. The credit rating at grade H is the threshold risk grade. Transactions between CBA and financial institutions with risk higher than grade H normally approved case by case basis. These deals often need to have collateral and no formal corbanking relationships could be established at this stage.

All corbanking relationships must be established by the International Business group at CBA Head Office in Sydney. CBA sees certain disadvantages in Corbanking including counterparty risk and lack of motivation to promote corbanking business because of
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different ownership, and lack of flexibility for providing some corbanking services in particular credit related services.

Profitability, revenue, returns on asset, growth in volume of business in dollars and overall performance of corbanking business were a little higher than other business in 1996. The profitability and overall performance of the CBA corbanking business is regarded as improving.

6.2.7 Strategies of Development of CBA Corbanking business

After completion of privatisation in mid-1996, CBA recognised one of its weaknesses: its international business needed to be readjusted. International correspondent banking is one of those businesses in need of an overhaul. There are a number of proposals and options for strengthening CBA international position. These include seeking international partnership alliances with another banks overseas such as a small country Asahi bank in Japan, Bank of New York for America, purchasing a medium size international bank with excellent international network such as the Standard Chartered Bank Asian network, setting up representative offices and or branches globally or even merging with an Australian major such as ANZ which has the best global networks. All the options seem to have no relationship with international corbanking. Nevertheless, as long as, CBA has decided to locate its businesses overseas usually it is customer driven and international corbanking is the most effective and cheapest way for it to expand globally. No bank in the world could have branches everywhere. International banks usually perform their businesses via their international branch network in the forms of subsidiaries or branches and correspondent bank network although lately it is common to have a joint venture overseas such as CBA’s 50-50 joint venture with Bank Internasional Indonesia. Asian corbanking businesses were the most profitable compared with other European and
American corbanking business in 1996. CBA has expanded its corbanking business in Asia in the Peoples Republic of China, Vietnam, Indonesia, Japan and other South East Asian countries.

The objectives for the principal corbanking strategies are: to reduce costs and increase revenue; to establish an efficient structure; to improve the skills of staff members including language abilities; to rationalise relationships and Nostro accounts and improve offshore branch support. The principal corbanking strategies and their analysis are hence listed as follows:

(1) Deploying Appropriate Corbankers. As part of the CBA overall staff cutting strategy, the current 17 corbank staff was to be reduced to 11 staff within the next 12 to 18 months following the conduct of this case study. The current organisational structure has three arms: correspondent banking, Australian Balance Sheet Relationship and Trade Finance will remain but the number of staff will be greatly reduced. Additional staff must create added value to the profit of CBA’s corbanking business. Benchmarking the corbanking business performance will be realised in very near future. The bank must also identify the right people for the jobs such as the recent recruitment of CBA’s corbankers from other majors as corbanking area managers who understand the business culture of specific countries (such as a Japanese to look after Japan market, and a Vietnamese to look after Vietnam market). Furthermore, effective use of management times to serve corbanks from different tiers. It is not necessary to have Relationships Executives to serve Tier 3 banker client; an Assistant Manager should be able to do the job. The size of the deals also needs to be taken into consideration in determining the level of staff to handle the transactions or negotiations.
(2) Recognising Income of Corbanking Products and Services. Various operational units such as ITPC and GPS charge fees and commission at cost for business provided by the Correspondent Banking unit. These charges are considered as costs of the corbanking unit. The difference between the revenues and costs is the income of the corbanking businesses. Operation units receive payment for services from banker clients but they only absorbed costs for operation services. In accounting records, for instance, a fee received by ITPC for processing a LC is paid by the corbanking unit; the banker client pays the corbanking unit a fee which is greater than the cost that is the fee paid to ITPC. An exceptional situation is related to treasury services and products. Usually the corbanking unit will split the fee 50-50 with the financial market unit for providing treasury services.

(3) Focus on Key Correspondents. Currently, CBA has more than 1,600 corbanks world-wide, which are categorised under three tiers as discussed in the previous section. Some 80% of the revenue actually come from major relationships or key correspondents. Therefore, it is not economical to maintain a large number of corbanking relationships since, usually the very basic requirement for having relationships with other bankers are to have reciprocal accounts, that is Nostro and Vostro accounts prior to the establishment of credit lines or formal contractual agreements. The new strategy is to focus and concentrate on further developing those major relationships to be key correspondents. For International Corbanking relationships, some 250 relationships out of existing 1,600 relationships have been categorised as Tier 1 and 2 relationships, it is expected that these will be further culled over the next 2 years to produce some 5 to 10 key relationships, and another 50 supporting/selecting relationships. Reducing the number of corbanks is to reduce the level of idle balances and to save administrative costs. Furthermore, the
bottom line for the selections is profitability, except in the case of certain international
corbanks, which are not profitable for CBA but CBA's customers insist to use them
overseas. In Australian Balance Sheet Business units, although the CBA's domestic
corbanking business mainly involved foreign banks in Australian, according to the
definition of international banking (Aliber 1984), this could be considered as a part of
international corbanking business. Four major relationships: SBC Warburg, County
Natwest, CS First Boston and State Street provided $650,000 net profit after tax (NPAT)
for 1995/96 financial year. In additional to these major relationships, CBA provides
domestic services to a number of other foreign financial institutions including Tokai,
Daiwa, First Chicago, Bank of China, and Monte Dei Paschi, mainly clearing services,
which accounted for about $1.2 to 1.5 million NPAT range.

(4) Exploit opportunities with Regional Australian Banks. Less attention has been
paid by CBA on the market to Australian banks, particularly the Regionals that have a
domestic corbanking market segment. CBA earns some revenue from domestic and
cross-border facilities provided to Regionals, but further opportunity exists, in both the
payments area, and other possible insource processing in particular international banking
services since Regionals do not have good international networks or have no experience
to run international businesses. This is related to the development of Regionals from
Building Societies, which do business locally, but the needs of their customers are forcing
them to go international.

(5) Increase Revenue Per Relationship - Cross Selling. A business development plan
for each relationship will be in place in order to increase revenue per relationship by cross
selling services to banker clients. Some relationships can not be further developed, and
those relationships with revenues that are below the set targets should be down graded or
transactions should be done on a case by case basis. Those relationships based on one-off transactions should be discarded.

(6) Further Develop Major Correspondent Banking Business. The Main sources of demonstrable income of CBA are *Vostro* balance float, trade finance and its processing, treasury services and products, and USD and AUD payment services for international banker clients. The major relationships are demonstrable revenue streams in *Vostro* balance float but the Key (top tier) relationships are expected to expand over a number of fronts of the sources of income. It is expected that the overall net income from *Vostro* less processing costs and cost of *Nostro* account balances will still increase tremendously. It is also estimated that Tier 1 and 2 correspondents will account for some 80% of the profit. Bank risk assumption and LC confirmation income should be targeted to increase twice the amount of 1995/96 with current correspondent client listing. Furthermore, CBA compared with other majors is rather underdeveloped in its correspondent’s Australian operations. ANZ and NAB are doing very well in their Australian dollar clearing services and related services. Therefore, CBA should further develop its services by packaging all products related to Australian dollar and offer them on product lines to banker clients overseas, Australian dollar products are in fact the strength of CBA’s services and products which are not very well exploited.

(7) Necessary to Manage Relationships to Preserve a Base for Business Development. It is necessary to maintain relationships and keep the relationships intact—not just key and support correspondents but also potential correspondents—so that they may be developed when systems/products of payment and other businesses are developed. The advancement of technologies and change of regulations may create new opportunities for new products
to be in place and for existing products to be further developed in order to fulfil the banker clients' needs.

(8) Improve Offshore Branch, Subsidiary and Representative Office Support. CBA as a Corbanker in the Head Office located at Sydney is remote from banker clients overseas who may have difficulties in accessing to information related to the client, for example, overseas country business and credit information of the banker clients, as well as of business deals. Therefore, offshore branch support is crucial in order to improve the corbanking business to assess credit risk of the overseas banker clients. Establishments such as offshore branches and subsidiaries, and representative offices are a part of CBA, which should be able to provide genuine and valuable information. Those overseas establishments could be used not just for surveillance of banker clients but also as contact points and sources of banking business for CBA and respondents. Certain branches and representative offices do take their own initiative to prepare country reports and overseas local bank reports for the CBA's Head Office.

(9) Developing of Fee and Commission-Based Income Business. As the competition pressure builds up in Australia, including reduction of interest margins, more players are coming into the market and securitisation is becoming a more common way of raising funds. Developing a fee and commission-based financial service is a strategy for CBA. Correspondent banking is one of these strategies to earn non-interest income.

(10) Excess Credit Availability. CBA has an excess capital adequacy ratio, more than the statutory 8%: Although it looks safer for CBA with a capital adequacy ratio of 12.71% as at June 1996, the excess should be used to make CBA more productive in terms of increasing profits by granting more credit for international business via corbanks.
(11) Customer Driven Development Strategies. Demand for international services is based on where the customers' business is going. Import/Export figures could be a good indication as to which countries are best for developing international banking businesses. CBA tends to have assets with banks located in Australia's major trading partners. In June 1996, United States (Asset with Financial Institutions, A$2,156m), Japan (A$2,428m), South East Asia (A$2,087m), United Kingdom (A$1,058m). The strategies are to further develop corbanking businesses in those countries along with studies of the nature of business composition. Furthermore, it will be more economical to appoint an agent bank to run CBA transactions and services for those countries not making profit such as Eastern Europe.

6.2.8 Future And Implications Of CBA Correspondent Banking
Some issues summarised below are relevant to future implications of CBA's corbanking:

(1) International Corbanking as a Business Strategy. CBA views corbanking as an emerging strategy for banking business development. Successful corbanks are those with a very clear understanding of what corbanking is, what their products need to be, who their customers are and what they want, and what level of service they need to provide. In a word, strategy.

(2) Factors Having Impact on Corbanking. Ranged from those of most to least importance: technology advance, risk reduction, concentration of services and strategic alliances, followed by regulation, globalisation, outsourcing and less labour intensive products. All will have an impact on the future of corbanking. CBA had invested a huge amount of capital to develop technology for banking services, such as the recent implementation of Internet Banking. CBA organised $5 billion alliance with information technology major EDS Australia on September 1997. The deal involves equity
participation and in two tiers: firstly EDS will provide services to the bank over 10 years, with two five-year options to renew. Secondly, CBA will take a 35% shareholding in EDS for about $240 million, a move which enables it to be part of the huge growth in the outsourcing market of technology.

(3) Problems Caused by Rapid Developments of International Corbanking. It is difficult to measure performance and quality of services; CBA’s corbanking unit is a relationships management orientated unit although income of payment and trade finance, and some treasury businesses could be measured by shadow accounts (a notional account to record corbanking revenue), similar to corporate finance units, other services such as lending are not easy to measure. Quality of service needs to be achieved by getting the right people, establishing error-free banking operations and a separate service centre to handle customer problems (Chang, Chan and Leck 1997). Others problems were development of new products and services and marketing.

(4) The CBA’s Long Term Strategies. CBA has a system focus on high value products and developing a multitude of relationships. Secondary strategies are, aiming at cost leadership in Australian dollar related products, and developing long-term customer relationships.

(5) Non-interest Income. Shrinking margins have forced CBA to increase its non-interest income.

(6) Strategic Alliances. Although CBA has no high level strategic alliances in international correspondent banking, it believes the main reasons for having strategic alliance is coping with complexities of international banking services and sharing costs and risk. Subsidiary reasons are: sharing knowledge and experience with banker clients and providing economy through co-operation on R&D and marketing, and to jump market
barriers. Currently, many Australian banks look for alliances in technology and high-yielding fund management, which are indirectly relevant to corbanking alliances.

(7) Integrated Distributor of Financial Services and Products. CBA revealed a plan to effectively become less of a bank in late 1997-to reinvent the CBA as an integrated distributor of financial services and banking products where corbanking services are part of them. “One-shop money shop is therefore created (Jacques, November, 11, 1997, The Bulletin).

(8) Benchmark. Benchmarking financial service activities including corbanking services have never been carried out in Australia, however, the best practices and management of corbanking are a good way to improve the corbanking performance of CBA via Management by Objective (MBO) as the best practice yardstick.

At the bank’s annual general meeting October 1997 the CBA launched a major strategic shift to remake itself as a retailer of a wide range of financial products. In a move designed to take advantage of sweeping reforms in the finance sector recommended by the Wallis Inquiry, CBA will create a holding-company structure and reorganise itself along functional, rather than product lines. CBA plans to revamp its entire retail operation, splitting it into three main business units - product development, marketing and sales. The aim is to position the bank to take advantage of its costly distribution network. The overhaul will benefit CBA via fast growth in investment and fund management products, which generate fee income. It will allow the bank to shift its business focus away from low-profit products, such as mortgages. CBA is also reacting to heighten competitive pressures in the finance sector, with non-bank lenders and industrial companies preparing to access the payments system in the wake of the Wallis Inquiry.
All these developments, though they are related to domestic banking, have an important impact on CBA's international corbanking in terms of strategies, income, product development, range of products, payment system. In international banking, CBA aims to satisfy its appetite for offshore growth by focusing on New Zealand, but will now approach Asia with significant caution (statement provided by the CBA's managing director on 30 October 1997). CBA had been eyeing joint-venture opportunities in India, China and Vietnam to complement its Indonesia joint venture but has shelved those plans as a result of the currency crisis in South-East Asia. PT Bank Commonwealth is capitalised at 150 billion Indonesian Rupian, which in June 1997 was valued at about $80 million, but now worth about $65 million after the sharp decline in the currency over the past month despite a satisfactory business record (Australian Financial Review, 31 October 1997, pp 46). Delaying setting up joint ventures in Asia, will probably provide opportunities for corbanking services in Asian countries.

(9) Internet banking. CBA is the first Australian major to provide comprehensive internet banking services. However, due to computer security issues, corbanking accounts settlement, in particular for larger amounts still use SWIFT, Test-key Telex and other payment netting working systems.

6.3 CONCLUSION

After privatisation, CBA has to stand on its own feet to face competition like other banks. Improving effectiveness, efficiency and profitability are the aims for CBA to remain as a major bank in Australia. Expanding internationally is one of the crucial strategies for CBA to be diversified for its businesses as well as to generate profit. Therefore,
corbanking is a banking business that has been identified by the senior management of CBA as an effective way but not the only way to expand overseas.

CBA defined corbanking as a total relationship management in terms of its implication for long-term business associates. CBA does not consider corbanking to be a bank’s core business. Compared with other majors, CBA had less developed international banking and corbanking business. Its international correspondent banking business is the responsibility of the International Business group of the Banking Services under a CBA major function-Institutional Banking. Clearing and trade finance services remain important corbanking products despite recent boosting of fund management business. World-wide corbanking relationships are controlled and managed by the Head office of CBA in Sydney, Harrington St. CBA operated itself as a corbanking provider as well as user with a system of risk management and relationships management including credit approval systems and the grading of counterparty risk and relationships. A few CBA’s corbanking strategies were: deploying appropriate corbankers, recognising income, focus on key correspondents, exploiting opportunities with regional Australian banks, increasing revenue per relationship, further developing major correspondent banking business, managing relationships to preserve a base for business development, improving offshore branch subsidiary and representative office support, developing fee and commission-based income business, using excess credit availability, customer driven development strategies. The findings of the literature reviews and hypotheses significantly fit into CBA’s perspectives of corbanking. Although CBA fully privatised in mid 1996, it remains one of the leading Australian banks. The case study of CBA presents the dimensions of an Australian bank dealing with corbanking business.
Looking to the future CBA’s corbanking is an emerging strategy. Technology advancement and risk reduction are the two most important for the future of corbanking. CBA has arranged an IT strategic alliance not just to outsource its requirements but also to take a stake in the alliance in order to share the growing outsourcing business. The measurement of corbanking performance and quality of cross border corbanking were two main problems of corbanking. Increasing non-interest income and high value products were CBA’s strategy management. CBA has no high level corbanking alliance but it believed the main reasons for having such an alliance are to assist CBA coping with the complexities of international banking services and the sharing of costs and risk. Integrated distribution of financial services and banking products is recognised as a strategy which is a “one-stop money shop strategy” by CBA’s management. Most banks have difficulty to measure their corbanking performance because of the nature of corbanking management. CBA has identified Benchmarking is an effective method to measure performance of corbanking services. Internet banking will be used for corbanking after further breakthrough of computer security in particular for larger amount transactions. Over the years a much diversified and complex range of banking products involving corbanking has been developed. Corbanking has become more akin to other areas of banking.

Although this case study is valuable in its own right as a unique case, it is also valuable as preliminary to the major survey in Chapter seven and modelling in Chapter eight. Furthermore, because the case is so intensive and generates rich subjective data it brings to light activities and management, processes, relationships and phenomena of international correspondent banking that deserve more intensive investigation. This case is also a source of hypotheses for further research by showing what corbanking is or that such an interpretation is plausible in a particular case and therefore might be so in other cases. The case seems typical in some ways of other banks. Conclusions reached are indicative rather than final.