

Best Practice of Selecting Strategic International Agency Banking

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ABSTRACT: International agency or correspondent banking (corbanking) is cross border bank to bank businesses that agent banks act on behalf of principals. Despite drastic changing banking environment, corbanking remains from doing business by mainly fee based, packaging reciprocal products and services, and so on. Corbanking is therefore identified as an alternative to serve clients worldwide in a strategic low cost way. Best practice to identify for entering corbanking relationships and selecting their correspondents are the themes of this paper, which are useful for financial institutions to make strategic and operational decisions for their expansion. Eighteen determinant factors to establish corbanking relationships and nineteen selection criteria of correspondents were identified through literature reviews, case studies, and exploratory surveys. Empirical surveys were conducted on 43 sample banks in Australia, which were further categorized in ten bank groups. Analytical methods included descriptive statistics and stepwise least square regression with case studies. The findings were: the most significant factor for financial institutions to enter correspondent banking systems was the bank size and a lower ranking factor was location not physically present, whereas there was different consensus for different bank groups about the selection criteria for agents overseas.

Keywords: Correspondent banking; Selection criteria; Strategy, Best practice; Cross selling

JEL codes: G21; L13

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1. Introduction

Correspondent banking (corbanking) is a term unfamiliar to the layman. It indicates that customers of a financial institution are other financial institutions. Unlike more obvious front-line services such as corporate banking and consumer banking, correspondent banking has always been viewed as a backroom operation. Nevertheless, its contribution to the whole financial institution is important. By maintaining a global network of interbank relationships, the correspondent banking department, or function, provides the necessary support and assistance to other departments within its own banking group. It can also act as a cross-seller of products of other business units within the bank. Banks and corporations competing in today's highly competitive and integrated business environment must adopt an increasingly global perspective or risk; otherwise, they will lose out in the long term. With the world integrating into a single universal market, correspondent banking will play an increasingly important role in facilitating the execution of international financial transactions.

At the beginning of this paper, literature reviews of the determinant factors of international correspondent banking and the selection criteria of correspondents of banks are overviewed. The best practice for the selection is to include important variables influencing customer or respondent bank choice: reputation, price and service (Kennington et al. 1996). Data banks are selected licensed banks of Australia in 2010-11. Models of the factors and criteria will be found by descriptive statistics, one sample t-test, and stepwise regression analysis according to the categories of ten bank groupings by types and countries.

2. Factors of international banking relationships

Banks may use a variety of organizational forms to deliver international banking services to their customers. These can include overseas branches or agencies, representative offices, correspondent banks, subsidiaries, affiliate companies, strategic alliances or fashionable joint-ventures. In the 1980s, in line with the development of international banking activities, leading banks not just in Australia began their inroads into international banking. They increased their global contacts and reinforced their international relations, which originated initially from trade links. Overseas branches and representative offices were set up in major financial centres and cities. Networks of bank correspondent increased worldwide.

The eighteen (18) determinant factors (Lawrence and Lougee 1970, Dewald and Dreese 1970, Meinster and Mohindru 1975, Dunning 1979, Palmer 1990) of international correspondent banking relationships that may have synergistic effects are: (i) customer driven - corbanking services are similar to other banking services which are to serve customer needs overseas in particular for domestic clients cross border. (ii) competitiveness - banks have currently paid more attention on corbanking businesses than say ten years ago. However, corbanking businesses are still not as competitive as other banking businesses such as corporate and home lending. Banks may use corbanking to expand its overseas markets for reducing their need to compete with other local banks. (iii) cost savings - good correspondent banking relationships can save costs. (iv) foreign market entry - certain respondents may use this as a means to enter foreign banking market as a starting step. (v) preventing fraud and money laundering - cooperation among correspondents and respondents are definitely effective measures to reduce criminal activities. (vi) access to overseas local markets - correspondents as agents of respondents are effectively

footholds of respondents on overseas markets. (vii) increasing bank assets - corbanking can be a way to expand asset sizes of banks in order to establish overseas reputation. (viii) improving efficiency - correspondents overseas as a representative an agent of respondents should improve efficiency for international banking transactions. (ix) competing international network - some banks use a corbanking network to complete their banking network in order to supply full banking services. (x) internationalization strategy (Dunning 1979) - this can be a strategy for international expansion. (xi) liquidity (Dewald and Dreese 1970) - international sources of supplying liquidity may be accessed effectively and cheaply through correspondents and their contacts. (xii) not physically present - although developments of technology reduce the importance for banks to be physically present, to date, many businesses still require banks physically present or be represented by their proxies. (xiii) minimizing capital investment - establishing corbanking relationships do not require huge capital commitment. (xiv) necessity and needs - respondents need to have their bank draft or telegraphic transfer/Swift and letter of credit cleared overseas which require correspondents. (xv) providing one stop banking - the corbanking relationships provide many other global services which contribute to one stop banking. (xvi) profitability - profits from interest rate margin are getting thinner but risk is not reduced because of competition. Fee-income based corbanking services can improve the profitability position of correspondents as well as respondents. (xvii) reciprocity - businesses come from reciprocal arrangements which are difficult to consolidate and guarantee. Finally, (xviii) bank size (Lawrence and Lougee 1970) - larger banks have the resources and may involve in variety of banking business as possible such as corbanking business.

3. Selection criteria of international correspondents

After banks have decided to establish their corbanking network, the next stage is to identify correspondents for operations. Although there are many banks all over the world, not all are trustworthy and credit worthy. This leaves the question of how to choose a correspondent bank. It is important to choose a correspondent on the basis of the bank's profile and overall business niche and policy. The bank will therefore need to assess the ability of the potential correspondent bank in servicing its needs. There is no standard formula or criterion in choosing a correspondent. It all depends on the reputation of the correspondent in the marketplace and the comfort level of the bank in dealing with the correspondent bank. With increasing competition in the marketplace, it is getting more difficult to choose right correspondent banks. There is also no definite answer as to the appropriate number and size of the correspondents. However, it would be useful to have more than one correspondent in each country but this must be carefully and continually evaluated. Hence, to make the right decision, the bank will have to pool information from its own assessment as well as advice from other banks to gauge the overall credit standing of a particular correspondent bank.

Nineteen (19) criteria (Krishanan 1990, Choo 1989) are identified as the key consideration as constructs to form paradigms in the choice of a correspondent bank: (i) broad domestic and global branch network - respondents look for correspondents because of their needs for any reasons overseas. Correspondents with broad networks are the basic requirement except specialist services required. (ii) effective account or relationship officers - many corbanking services needed to complete within short span of time with good level of accuracy which required effective officers to carry out the works. (iii) financial strength in terms of financial

resources, quality and stability - it is always prudent to deal with a financially sound bank. The performance of the correspondent bank will have to be evaluated by its financial statement reviewed. Another factor to consider with regards to a correspondent bank's financial strength is the evaluation of the risk-taking policies of the correspondent bank which will affect its future ability to service its obligations. The evaluation of the asset quality and capital adequacy of a correspondent bank is relevant especially when the business conducted is very much credit-related. (iv) formal banking presence - it is a prerequisite that a correspondent bank must have a formal banking presence in the country in which the underlying customer wishes to do business and where the transaction initiating bank is not represented. It would therefore be useful for a correspondent bank to have a global network of offices especially if the bank's customers also have a global branch network. (v) effective and efficient products and services delivery - many corbanking services required to be speedy in which mistakes made by correspondents may be very expensive and taken long time to correct. (vi) historical relationships - many implications among respondents and correspondents include good rapports in terms of transaction arrangements, speed to complete transactions and credit background of each other. (vii) innovative product design - correspondents should be innovative in product design to respond to the ever changing market conditions. (viii) linkage to SWIFT and Netting - that is communications capabilities, a correspondent bank with links to SWIFT and/or local tele-networking such as CHIPS, CHAPS and/or private electronic funds transfer systems will have the capability to communicate and report any messages to its counterpart efficiently and in good time. (ix) location - good locations may mean easy access to overseas local market and resources. (x) market reputation - the market reputation of a correspondent bank is an important criterion in selecting a correspondent bank. A bank will not know whether another bank is a good pay master or a defaulter unless it has dealings with that bank. Thus in order to arrive at the best decision, a bank, which does not have previous business contact with a potential correspondent bank, will have to rely on the feedback of other banks which have previous dealings with that potential correspondent bank. (xi) operational capabilities - many corbanking services have operational nature, and then correspondents must be able to cope with those services. (xii) consistent business policy - respondents preferred to have stability over many aspects such as pricing, foreign exchange covers, and credit granting (xiii) pricing - certain respondents are cost conscious but prices for last minutes or speedy corbanking services may be high; nevertheless, a good correspondent bank should not price its products and services too differently from the market. It should instead adopt a competitive pricing method that is in line with the market. (xiv) a range of services - respondents would normally want to choose a correspondent whose products and services are able to fit into its core business and strategic business niches. Furthermore, correspondents should be able to provide good customized services. (xv) reciprocity - this used to be an important factor to consider since banks depend on each other businesses. Reciprocity could be giving businesses to each other which ranged from signing a bilateral agreement to verbal arrangement for narrowed range of services and products such as clearing and trade-related services to broadened range of any bank services and products. (xvi) risk rating - risk related problems will ultimately go to not just respondents but also customers of respondents. Country risk has strong impact on business transactions. It is essential to consider the economic and political environments of the country where the correspondent bank is located. This is important since the policy of that country may prohibit correspondent banking activities. For instance, a correspondent bank may be prohibited from transferring funds out of the country by its government even though it has sufficient funds to meet its obligations.

(xvii) service compatibility - respondents and correspondents must be compatible in terms of corbanking services which may involve market and customer segments, hardware and software. Regional banks do not use Majors as their international correspondents which may take away their customers. (xviii) reliability of supply - this is an element of quality of banking services, the corbanking relationships will not last without reliability of supplying services. (xix) technology level - effective and speedy delivery of services require high level of technology.

The nineteen criteria are actually related to the management of the bank. Two principal areas are composition of the management team and quality of management. In the former, financial strong banks may be inefficient due to its ineffective management team. It is therefore crucial to find out the background and reputation of the bank managers and especially the key personnel in the management team. In the latter, the quality of management depends on how much on its managerial policies and the implementation of these policies. Moreover, strong operational capabilities of a correspondent bank will be necessary to handle and process all business efficiently and with minimum delay. It is also helpful to have a pool of high calibre officers who possess the necessary skills to market the bank's products.

4. Main findings

Finding 1: Stepwise Regression (SR) Results for the determinant factors of international correspondent banking are shown in table 1.

Having imposed conditions: the test value was important scale 3 and the statistical significant level was <0.05 in order to choose acceptable factors out of the eighteen factors from one sample t test results for descriptive statistic data, the chosen factors then became explanatory variables for modeling by stepwise regression. Bank grouping models were established for ten bank groups: All, Australian, Foreign, Majors, Non-majors, American, British, Japanese, European, and Asian banks by discrimination process of nineteen factors.

In the All bank model, bank size and location not physically present are important factors with respect to due from other banks, in particular the single most significant factor bank size.

In Australian banks, bank size is the single most significant factor with respect to due from other banks as in the merger and acquisition activities such as Metway, QIDC and Suncorp merger, St George and Advance Banks merger. However, Majors still stressed the customer driven factor as the most significant factor with respect to number of correspondents for its international correspondent banking. The significant bank size factor in regard to due from other banks of the Non-majors model was rosy with improving banking services and profitability by the regional bank size.

Table 1: Results - Bank Group Models of Determinant Factors of International Correspondent Banking

Most Significant Bank Groups	t Value	Models
1) All Banks RSQ = 0.6341		D1 = 0.0165 I1 + 1206708 I13 + 13.3007
• I1 Bank Size	8.186***	F = 34.66
• I13 Location not Physically Present	2.432**	
2) Australian Banks RSQ = 0.7560		D1 = 0.0153 I1 + 235.8405
• I1 Bank Size	6.35***	F = 40.27
3) Foreign Banks RSQ = 0.5775		D1 = 0.0880 I1 + 131.1345 I13 - 217.0701
• I1 Bank Size	5.32***	F = 17.08
• I13 Location not Physically Present	2.88**	
4) Majors Banks RSQ = 0.994		D2 = 3796.0000 I12 - 2346.0000
• I2 Customer Driven	18.24**	F = 332.53
5) Non-majors Banks RSQ = 0.9521		D1 = 0.0544 I1 - 73.9888
• I1 Bank Size	13.38***	F = 178.92
6) American Banks RSQ = 0.8224		D1 = 0.0859 I1 + 112.6623
• I1 Bank Size	4.81**	F = 23.16
7) British Banks RSQ = 0.6684		D3 = -0.0383 I11 + 0.2219
• I11 Internationalization Strategy	-3.18*	F = 10.08
8) Japanese Banks RSQ = 0.9659		D2 = -153.50 I12 + 810.50
• I12 Liquidity	-7.52*	F = 56.60
9) European Banks RSQ = 0.9985		D2 = 0.02 I1 + 103.61 I10 - 210.61
• I1 Bank Size	11.43**	F = 682.05
• I10 Complete International Network	26.68**	
10) Asian Banks RSQ = 0.9402		D3 = -0.065 I8 + 0.3345
• I8 Increase Bank Assets	-6.87**	F = 47.18

Notes: All models with F statistics >4, that is all are significant
 Significance: *<0.05, **<0.01, ***<0.001

In the Foreign banks model, the result was similar to All banks in which bank size and location not physically present were the two important factors particular bank size with respect to due from other banks in general for all foreign banks in Australia. For American bank model, bank size with respect to due from other banks was the most significant factor despite American banks tended to be marketing orientated and hence improving profitability. The internationalization strategy with respect to the ratio of due from other banks and bank size was the most significant in the British bank model with the evidence such as Standard Chartered and Hongkong banks were active global banks. The liquidity factor with respect to the number of correspondents was the most significant factor of the Japanese bank model. Japanese banks see each other as formal or informal association or alliance overseas supplying corbanking business and liquidity to each other. It is impossible for banks to set up branches in every location in the globe; therefore, European banks complete their international network by a branch network which is also supplemented by an international correspondent bank network. The increase bank size factor with respect to the ratio of due from other banks and bank size of the Asian bank model was the significant factor explained why Asian banks involved in international correspondent banking.

Reliability was strongly acceptable by 0.870 Cronbach's alpha of the data. All models had a single explanatory variable except All, Foreign and European banks with two explanatory variables which had no multi-collinearity problem indicating by high tolerance (>0.81).

To have general findings, the bank size factor was the most general factor since it was a factor for six bank groups: All, Australian, Foreign, Non-majors, American, and European banks. The location not physically present factor was relevant to two bank groups: All and Foreign banks. Other factors such as the customer driven factor (for Majors banks), the internationalization strategy factor (for British banks), the liquidity factor (for Japanese banks), the complete international network factor (for European banks) and the increase bank assets (for Asian banks) were vital determinant factors to entry corbanking business in their respective bank groups.

Finding 2: Stepwise Regression Results for selecting criteria for correspondents.

Having imposed conditions: the test value was important scale 3 and the statistical significant level was <0.05 in order to choose acceptable factors out of the nineteen factors from one sample t test results, the chosen factors then became explanatory variables for modeling by stepwise regression. Significant bank grouping models were established for eight bank groups: Australian, Majors, Non-majors, American, British, Japanese, European, and Asian banks by using discrimination processes of the nineteen criteria.

The explaining strength of All bank model (Adjusted R Square = 0.1046) and Foreign bank model (Adjusted R Square = 0.1477) for their dependent variables were weak.

In the Australian bank model, reliability of supply, operational capabilities and linkage to SWIFT and Netting were significant especially reliability of supply. Linkage to SWIFT and Netting criterion in the Majors model indicated that Majors needed their correspondents to have at least basic communication facilities. Majors had branches in financial centres and major cities in the world but not other locations which critically required to have better telecommunication facilities.

The formal banking present and technological level criteria were significant criteria of Non-majors. Understanding Non-majors did not have effective and efficient branch network and facilities, therefore, Non-majors required their correspondents to present in certain locations and acceptable level of technology to remedy their deficiencies in international banking businesses. The formal banking present with respect to number of correspondents was the most significant criterion for American banks which were beneficial from their correspondents having bank license and legal present at overseas location such as access to the locations.

The compatibility of services and historical relationships were significant criteria of the British bank model especially the former. The compatibility of services actually can contribute more effectiveness and efficiency to deliver corbanking services which served the needs of British banks. Long history British banks had many long-term banking relationships in existence. British banks probably understood their correspondent ways of doing banking businesses through working together for long period of time which formed a linkage between the two criteria.

The financial strength and market reputation with respect to due from other banks to bank size were significant criteria of Japanese banks. The two criteria of Japanese banks were related to creditworthiness. Japanese banks preferred to use other Japanese banks as their correspondents which were probably related to their understanding Japanese banks stability and performance and easy access to banking information within the same Japanese banking system on one hand and Japanese business culture on the other. Therefore, Credit standing of Japanese banks was accessible to Japanese in contrast to non Japanese banks as correspondents.

The formal banking presence and range of services were significant criteria of the European bank model. Most European banks such as Deutsche, BNP and Credit Suisse had branches in major financial centres and cities in the world, the reason for them to have correspondents with formal banking present was to have good access to local markets.

The operational capabilities and location were significant for Asian banks. Correspondent services are mostly operational such as clearing cheques, opening letters of credit and trade finance settlements. Asian banks focused on operational capabilities and location which composed abilities of correspondents to effective delivery services and products.

Reliability was strongly acceptable by 0.8697 Cronbach's alpha of the data. Two bank groups: Majors and American bank models had a single explanatory variable. Five bank groups: Non-majors, British, Japanese, European, and Asian bank models had two explanatory variables but the Australian bank group established three explanatory variables which all had limited multicollinearity problem indicating by high tolerance (>0.46).

To have general findings, Non-majors, American, and European bank groups chose the formal banking present as merely or one of their criteria. The operational capabilities factor was relevant to two bank groups: Australian and Asian banks. The location factor was relevant to Asian banks. Other factors such as the reliability of supply (for Australian banks), linkage to SWIFT and Netting (for Majors), technological level (for Non-majors), historical relationships (for and compatibility of services (for British banks), financial strength and Market reputation

(for Japanese banks), and range of services (for European banks) were selecting criteria for respondents in their respective bank groups. The leads to different banks have their own views to choose their correspondents with respect to their global strategies.

5. Conclusion

The causes of a rapid changing banking environment include deregulation, competitiveness, and technology advancement which is turning bankers to enrich and enlarge their businesses by looking at alternatives such as fee based correspondent banking business. Fee based business basically can have a steady revenue for banks with little risk compared with interest based income. International Corbanking services have even become a core business for banks such as Standard Chartered, BOA, and Chase. It is therefore very useful to find the reasons for banks to entry correspondent banking relationships as well as to select their correspondents, for banks to evaluate their strategies. Surprisingly, models formed by stepwise regression were simple in the formats of one or two independent variables explaining the dependent variable. Each model of the ten bank groups was formed for factors of international correspondent banking relationships and selecting criteria of international correspondents. The findings were: there are one or two determinants of ten bank groups to enter corbanking relationships. Bank Size (the most important) and location not physically present (less important) are factors for decision to establish their corbanking relationships networks although each and every bank group use different factors. Different bank groups have their own preference on the selection criteria for correspondents. Australian banks tend to identify linkage to SWIFT and Netting.

For major limitation, All bank group (43) and Foreign bank group (28) are statistically accepted sample size, however, other bank groups are with smaller sample size therefore their results may not be reliable but they support detail analyses of All and Foreign bank groups. Further research and improvement will be achievable when the bank population in Australia increases.

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