

# STRATEGIC CROSS BORDERS REACH BY GLOBAL ALLIANCE BANKING

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## ABSTRACT

Global Correspondent banking (Corbanking) is basically cross country bank to bank businesses that established by international Agency or Alliance Banking relationships. With the changing banking environment driven by further deregulation, increased political and monetary integration, changing attitudes to risk, competition among banks and the non-bank sectors, corbanking remains from doing business by mainly low risk non-interest income. Corbanking is therefore identified as a good alternative and supplement to achieve profit and share price target. Critical analyzing the strategic alliance nature and development of corbanking relationships, and reasons of entering corbanking relationships and selecting their correspondents are purposes of this paper. Comparative advantage and its exclusivity, customer service rationale and internationalization are elaborated, following by summarizing literature review and exploratory surveys, Eighteen (18) potential determinants to establish corbanking relationships and nineteen (19) potential selection criteria of correspondents are identified for further analysis. Analytical methods included descriptive statistics and stepwise least square regression which are applied to 43 sample banks in Australia classifying under ten bank groups. The findings were: the most significant determinants 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. A case study of a Chinese's major confirmed those factors and criteria.

**Keywords:** Correspondent Banking, Selection Criteria, Strategy, Best Practice, Cross Selling.

## 1. Introduction

Agency or Correspondent banking (Corbanking) is basically bank to bank business practices providing of financial services by one bank to another. 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, important international corbanking characteristics will be elaborated: Literature of strategic nature and development, customer services and internationalization of corbanking. 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 & Carolyn 1996). Data banks are selected licensed banks of Australia in 2012. 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. A case study of a Chinese major will be applied to confirm the findings of the previous discussion.

## 2. Literature of the strategic alliance nature and development of corbanking relationships

The age of corbanking is nearly the same as banking itself. The old corbanking relationships were the close social relationships between correspondent and respondent bankers which, in fact, helps to reinforce mutual trust (Fin, 1992). The services rendered by correspondents were friendly, personal and helpful under the reciprocal relationships with partially compensated by account balances where almost no bank used corbanking as a strategy for international banking development. With the changes of banking environment, the strategies from developing corbanking and banking as a whole have been changed. Four short term strategies are commonly used by leading correspondent banks in London: Heavy promotion for good corbanking services; Control of payment systems in a

relatively small economy such as in Australia; Use of networks for selling; and Use of reisk differential for profit. Whereas, emerging strategies for the long terms by corbanking leaders include Cost leadership; High value or services product focus involves innovative, flexible information systems, rapid system development and quality services; High volume involves effective systems cutting unit cost by volume; a long-term customer relationships involve selective customers providing with high level of services by cost controlling cost and prices (Mainelli, 1994). The bank merger and consolidation trend will continue therefore reduce the number of banker clients for corbankers. Corbankers should share the benefits of their experience and offering services demanded which are important factors of corbank's strategies. Forming strategic alliances and continue to provide quality service, quality products, competitive pricing will also crucial to corbanking business development (Rourke, 1995) and take away the competitive pressure. Linking up all corbanking relationships with potential will form solid integrated networks and putting all small potential corbanking relationships together as alliances will also improve the strength for competitiveness. Some banks considered corbanking as a transition stage of formal entry to a foreign market, the strategies of corbanking will definitely build the strong foundation and connection for respondent banks ultimately established direct investment.

### **3. Comparative advantage/Exclusivity**

There are a whole list of comparative advantages over other banking businesses, some of those are listed as follows:

- a) Stable and good quality earnings are originated from balances and fee based income. Respondent banks are still maintained some balances in vostro accounts which could improve cost of funds of the corbank. Large portion of corbanking income is fee based income without equity backing requirements which is not just improve the corbank return on assets but also return on risk adjusted assets.
- b) Comparative low risk banking businesses is generally due to banks having lower credit risk and being stringently regulated than corporate business.
- c) Sharing fixed operating cost is due to more business volumes for corbanks or excessive capacities bought and used by respondents such as increased number of transactions for the corbank's payment system and hence unit cost is been reduced.
- d) Clients recommended or redirected by the respondent banks who have the potential corporate relationships with the corbank.
- e) Reciprocity is still in existence between banks but with different perspective. It also is the first step of identifying potential strategic allcnces in foreign markets.
- f) A good international corbanking network for the bank is one of the crucial requirements to provide banker clients and corporate clients with quality and complete banking services.

### **4. Customer service rationale for corbanking**

This rationale arise from the needs arise from the needs, wants and motives of the banker clients. Corbanking traditionally arose purely out of necessity which therefore were not actively marketed (Wilkins, 1993). Although the corbanking business is still a customer driven business, the changing and increasingly competitive international banking environment causes corbanks to seriously look at the level of customer services. Literature had listed down the main elements of customer service (Christopher, 1987). Customers who are distant might be more concern about the guarantee of reliable rapid availability than customer much closer to the domestic bank. More importantly, not all banker clients will use all the corbanking services but selective services. Therefore, customized or tailor-made corbanking services to the needs of individual banker clients are appropriate ways for providing customer services. The ability and corporate capability of corbanks to meet widely differing customer requirements in different countries needs to be managed in due course.

### **5. Internationalization**

Dunning's eclectic theory (Dunning, 1979) is applied by Gray and ray (1981) to multinational banking where preservation of established customer accounts, entry into growth markets, economies of international operation, ensuring control over capital sources are also relevant to the three advantages which are also applicable to corbanking.

In additional to the factors, the most important factor for banks engaging in international banking are serving the needs of their customers, then others such as the profit motive, global expansion and global diversification (Fraser, Gup, Kolari, 1995). The mode of entries for internationalization can be by foreign branches, foreign subsidiaries, representative offices, joint venture, corbanking, and the mix of considered forms which involve different composition of commitment in terms of equity, capital and businesses. Selection of suitable forms to enter foreign markets has to be put into context where circumstances under certain conditions sometimes are not just economic reasons but also legal, political and even cultural. International corbanking tends to have the least equity commitment and less barriers to use comparing with other forms of entries. Although it established was out of necessity to serve clients, many banks use it as the initial entry for international market (Chan & Naughton, 1996).

International banks adopt its international branch network (including branches, subsidiaries and joint ventures) and supplemented by a international corbanking network in order to complete its international network. Regardless reasons other than economic rationale, further reasons for selecting corbanking or agent banks are resource constraint because no bank can have all expertise. Sometimes specialist bank can provide specialized services and products such as treasury products better than big banks; others include transactional cost economics (Jones, 1993) risk averse for the respondents Corbanking uses to observe, check and familiar the target foreign markets prior to decision or maturity for direct involvement based on commercial justification such as volume of trade. Nevertheless, not all international banks prepare to commit in the forms other than corbanking which has its limitations and counter party risk that is the agent bank behaves in an opportunistic fashion in addition to normal banking risk. Dunning's factors do applicable to corbanking in context probably despite Australian banks do not possess ownership advantages in intermediation services (Merrett, 1995). Ownership specific advantages are not needed in the less regulated or unregulated market such as Asiamarkets and Euromarkets where corbanking relationships are sufficient to function well in the supranational markets (Gay and Gay, 1981)

## 6. Determinants 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 & Lougee 1970, Dewald & Dreese 1970, Meinster & Mohindru 1975, Dunning 1979, Palmer 1990), of international correspondent banking relationships may have synergistic effects which are: (i) customer driven, (ii) competitiveness, (iii) cost savings, (iv) preventing fraud and money laundering, (v) access to overseas local markets, (vi) increasing bank assets, (vii) improving efficiency, (ix) competing (x) internationalization strategy (Dunning 1979), (xi) liquidity (Dewald and Dreese 1970), (xii) not physically present, (xiii) minimizing capital investment, (xiv) necessity and needs, (xv) providing one stop banking, (xvi) profitability (xvii) reciprocity, Finally, (xviii) bank size (Lawrence and Lougee 1970).

## 7. Selection Criteria of International Correspondents

After banks 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 criteria 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 numbers 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 assessments 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 identify as the key consideration as constructs to form paradigms in the choice of a correspondent bank: (i) broad domestic and global branch network, (ii) effective account or relationship officers, (iii) financial strength in terms of financial resources, quality and stability, (iv) formal banking present (v) effective and efficient products and services delivery, (vi) historical relationships, (vii) innovative product design,(viii) linkage to SWIFT and netting, (ix) location, (x) market reputation, (xii) consistent business policy, (xiii) pricing, (xiv) a range of services, (xv) reciprocity, (xvi) risk rating, (xvii) service compatibility, (xviii) reliability of supply, (xix) technology level. 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.

## 8. Findings of Selecting Corbanking System and Respondents

**Finding One:** 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 and 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. The merger and acquisition activities such as Metway, QIDC and Suncorp merger, St George and Advance Banks merger, and majors looking for targets. 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-major model was rosy with improving banking services and profitability by the regional bank size.

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.

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

<i>Most Significant Bank Groups</i>	<i>t Value</i>	<i>Models</i>
<b>All Banks RSQ=0.6341</b>		<b>D1 = 0.0165I1 + 1206708I13 + 13.3007</b>
I1 Bank Size	8.186***	F = 34.66
I13 Location not Physically Present	2.432**	
<b>Australian Banks RSQ=0.7560</b>		<b>D1 = .0153I1 + 235.8405</b>
I1 Bank Size	6.35***	F=40.27
<b>Foreign Banks RSQ=0.5775</b>		<b>D1 = 0.0880I1 +131.1345I13 -217.0701</b>
I1 Bank Size	5.32***	F=17.08
I13 Location not Physically Present	2.88**	
<b>Majors RSQ=0.994</b>		<b>D2 = 3796.0000I12 -2346.0000</b>
I2 Customer Driven	18.24**	F=332.53
<b>Non Majors RSQ=0.9521</b>		<b>D1 = 0.0544I1 - 73.9888</b>
I1 Bank Size	13.38***	F=178.92
<b>American Banks RSQ=0.8224</b>		<b>D1 = 0.0859I1 + 112.6623</b>
I1 Bank Size	4.81**	F= 23.16
<b>British Banks RSQ=0.6684</b>		<b>D3 = -0.0383I11 + 0.2219</b>
I11 Internationalization Strategy	-3.18*	F=10.08
<b>Japanese Banks RSQ=0.9659</b>		<b>D2 = -153.50I12 +810.50</b>
I12 Liquidity	-7.52*	F=56.60
<b>European Banks RSQ=0.9985</b>		<b>D2 = .02I1 + 103.61I10 - 210.61</b>
I1 Bank Size	11.43**	F=682.05
I10 Complete International Network	26.68**	
<b>Asian Banks RSQ=0.9402</b>		<b>D3 = -.06518 + 0.3345</b>
I8 Increase Bank Assets	-6.87**	F=47.18

Notes: all models with F statistics >4, that is all are significance

Significance: \*<.05, \*\*<.01, \*\*\*<.001

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 a 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), 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 Two:** 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 & 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 correspondents 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 multi-collinearity 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 & 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.

### **9. Case Study: Bank of China, Sydney**

Bank of China's (BOC) view of the future of correspondent banking and strategies of corbanking: Banking businesses including corbanking become very competitive and banking products and services become complicated and therefore the risk. BOC Australia's important strategy appears consistent with the parent company's stated vision of helping bridge trade between China and Australia, and hence boost the development of Chinese economy. Chinese from mainland China or Hong Kong invest in property markets in Australia and overseas and list Chinese company share in Australia Stock Exchange. The bank's strategy of fiscal prudence has also helped the bank better weather difficult financial times in Australia, better than many of its competitors such as Hongkong bank and Citibank. The business of Bank of China is expanding in terms of range of products and services such as recent BOC has started to involve in capital market transaction, trade settlement by yuan in China from overseas. In addition to the Chinese government is opening the Chinese yuan business for foreign bank in China which, in fact are the opportunities for BOC. Furthermore, BOC becomes yuan payment and trade settlements centres overseas including Australia for cost saving of converting of foreign exchange BOC sees corbanking as one of the important strategies for doing international business and low cost international expansion for now and future.

BOC will continue to use corbanking as ways to perform international banking business because of less equity commitment and barriers to have branches in some countries. The future strategies of BOS's corbanking are further centralised corbanking management including risk management, credit control and relationships management. Although the business volume of Sydney branch is not justified to establish a corbanking department, a special trained full time staff will manage and centralize the bank's corbanking business with a budget rather than taking care by various departments. The staff will also carry out marketing products and services to other banker clients and co-ordinate corbanking regional offices worldwide and Head office however, the emphasis is on the risk management of corbanking business rather marketing orientated.

### **10. Conclusion**

Non-interest income of corbanking such as 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 all banks to enter corbanking relationships. Bank Size is the most important and location not physically present is 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 & Netting. A case study of a Chinese major bank apparently applied to confirm the findings by quantitative methods.

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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