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# 'Private Banking' and Depreciation of the Rupee

**Kannan Srinivasan**

*The recent volatility in the foreign exchange market has been discussed almost entirely in terms of the Reserve Bank of India's behaviour, whether it intervened 'in time' or in the right way, and so on. But considering the scale on which portfolio funds and 'other capital' have entered India in the last two years, the recent developments need clearly to be looked at in the context of international capital flows.*

THE current panic in India's foreign exchange markets ought to alert us to the fragility of the base on which the liberalisation programme has been erected. The single demonstrable achievement of the 'reforms' programme has been the build-up of the foreign exchange reserves; but that build-up has taken place due to inflows of hot money – portfolio investment, the entry of funds through the havala route, and such mysterious channels as the 'other capital' head in the capital account of the balance of payments. Such capital is particularly prone to fly abroad again whenever there is a foreign exchange crisis.

The press has reduced the discussion of the recent volatility in the foreign exchange market to one of the RBI's behaviour, whether it intervened 'in time' or in the right way, and so on. But portfolio funds of the order of $ 7 billion entered India during April 1993-March 1995, and 'other capital' accounted for another $ 4 billion or so during the same period. So we clearly need to look at the recent crisis in the context of international capital flows.

In the last three years, there has been much comment on the increased volatility of such flows. But one aspect has been neglected. That is the increased importance of 'private banking' to the international banks. This is particularly relevant in the case of India. It is well known that most of the portfolio investment and NRI deposits are the funds Indians have taken abroad. Another avenue for such flight capital's entry and exit is through the under-invoicing or over-invoicing of trade (the 'havala' route). It is the movements of such flight capital that will determine whether and how fast the rupee will depreciate.

## Debt Crisis

The global phenomenon of such flows of money arose from the rescue operation for the international banks performed after the LDC debt crisis. Contrary to popular perception, this debt has been no disaster for the international commercial banks. Their losses may be outweighed by the returns of the original loans to the third world combined with the important new business opportunities which have arisen as a direct consequence of that lending.

During the years 1972-1982, sovereign long-term lending was significantly more profitable than most OECD business. As countries borrowed amounts they were unlikely to repay, short-term lending at very high interest rates earned handsome returns. The management of flight capital boomed in 1982 when Latin American countries stopped repayment. It has flourished ever since.

As the Fund-Bank restructuring gathered pace, banks launched asset management companies to invest in third world stock markets. They developed profitable stock market, consumer and merchant banking businesses in those countries. LDC profits have constituted a major portion of overall banking profits. Some banks have made money nowhere else.

At hearing of the Senate Subcommittee on International Finance and Monetary Policy, when asked (February 8, 1989) whether "a lot of our banks really made money on the front end of these loans, a lot more money than a lot of us realise", Jeffrey Sachs – not known to be excessively tenderhearted to the third world – replied:

> all of the banks, everything (*sic*) in this country is (*sic*) out of the crisis right now. They did get the large front-end fees at the time. Indeed, in the early reschedulings, the name of the game was when the country got into trouble, raise the spread for a few years. Finally, that's been whittled down, but you know it is interesting with the hundreds of commercial bank restructurings, there hasn't been a single case of a submarket interest rate, not one single case. There's been a positive spread on every single restructuring that has been made. That is for 42 countries, each of which have (*sic*) had two or three rounds at this point.

For some years after 1982 it seemed that third world borrowers might default. From this the banks have learnt the importance of avoiding long-term commitments. All five important areas of LDC business done today – consumer finance, merchant banking, institutional investment, private banking and short-term lending – involve limited and very temporary exposure to the uncertainties of world trade and third world economies, and provide great flexibility of entry and exit. Today's boom in 'emerging markets' and other swift flows of international capital is a direct outcome of that original involvement in LDC activity – modified to minimise risk.

## Private Banking and Capital Flight

A significant part of this swift global movement of capital has been intermediated by the *private banking* operations of international banks. "Private international banking" is, as Columbia University professor *Karin Lissakers* calls it, "the banking community's euphemism for the solicitation and investment of flight capital".

Money borrowed by third world countries returned to the international banking system even when – indeed, especially when – countries defaulted. Inflows of flight capital from wealthy private individuals in defaulting LDCs have more than offset the amounts of money lent to those countries. Such capital has generally been taken out of a country in evasion of foreign exchange regulation. Often it has been criminally acquired from trade such as narcotics, or in bribes and commissions for contracts. These funds are re-lent or reinvested. Flight capital may even serve the same purpose in providing liquidity to the international banking system as did OPEC funds during the 1970s and 1980s.

Asia and Latin America provide the major growth in private international banking for these banks worldwide, not the OECD economies. In virtually every country in southern and central America, political and economic uncertainty persists. In Asia such risk is most strongly evident in the Philippines and south Asia.

To the banks, the first benefit is one of liquidity. For instance, such client assets exceeded $ 52 billion for Chase Manhattan Bank alone in FY 1992. This is an amount equivalent to nearly its total deposit base of $ 53.7 billion.

Now private bankers estimate that between 20 per cent and 40 per cent of such assets managed by a bank end up in its own deposit base. Private bankers recommend a prudential ratio of diversification of investments, between real estate, bonds, moneymarket funds, stocks and bank deposits. A significant percentage would also transit through the bank's deposit base as it must be deployed in one or other of these investments.

Chase's Annual Report (1992) points out that a dramatic growth in client assets – of 10 per cent every year – puts "us in the top 10 largest financial institutions serving the money management needs of the wealth market... The global private banking business has tremendous growth opportunities, particularly in Asia and Latin America." It estimates the private international banking market worldwide at "$ 10 to $ 15 trillion and no single institution can claim a dominating share". Its 1991 Report says: "Because private banking clients come from all over the world, Chase's private bankers are multilingual. The Chase approach to private banking is to build trusting relationships, ensure confidentiality..."

Similarly, in the case of Citicorp, such private banking clients provided funds of $ 75 billion for investment – equivalent to nearly half of its deposit base of $ 146.47 billion. Its 1992 Report says: "The Citibank Private Bank provides an integrated wealth management service through long-term, personal client relationships serving wealthy individuals, their families and, as appropriate, their businesses. In 1992, the Private Bank's worldwide client base expanded by 5 per cent to 74,000, and total assets under management rose 7 per cent to 75 billion ... The largest non-Swiss private bank in the world .. with 91 offices in 28 countries". The Private Bank claims to deliver Citi's global expertise in the process of "protecting and enhancing its clients' real wealth". In 1991 Citibank noted that ".. private banking activities in Asia and Latin America achieved record earnings... private banking combined net income for these regions increased 15 per cent over 1990 results".

Bankers Trust manages $ 25 billion in private banking assets. Salomon Brothers says in its analysis of BT (March 1992): "the company's network extends beyond its four US offices – in New York, Chicago, Miami, and Los Angeles — to London, Hong Kong and Switzerland. The target market remains cross-border money flows" which can be "serviced from a limited number of locations".

American Express Bank (AEB) has seen capital flight money increase at rates of 15 per cent to 18 per cent through the late eighties early nineties. Such 'client funds under management' have actually exceeded the total deposit base of the bank. Five years ago (1987) its Annual Report declared that: "Private banking is the cornerstone of the American Express Bank strategy, in line with the bank's focus on low-risk, fee-generating services... private banking client holding grew 18 per cent to $ 12.2 billion." By the following year such 'client funds under management' rose to $ 14.29 billion. As the chairman boasted, these had actually tripled in five years – from $ 4.5 billion in 1983. As in the previous year, this exceeded the bank's entire deposit base – 'customers' deposits and credit balances' which amounted to $ 13.035 billion. That "strong growth pattern" continued. By December 1989, capital flight money increased 18 per cent to $ 16.4 billion. By 1990, however, the bank had become more coy. No specifics were provided (in numerical terms) of private banking clients or their assets.

The bank restricted itself to advertising its services. That Annual Report begins: "American Express Bank will become the world's pre-eminent exclusive global financial institution for wealthy individuals. We will meet their needs 24 hours a day, seven days a week, anywhere in the world, for wealth accumulation, wealth preservation and prestige convenience by providing the personal financial services they need to manage their wealth and to ensure access to it wherever they may be..." Appropriately enough this manifesto is called its *Vision Statement*.

Indeed this and other third world business have offset the losses that Amex and other banks have made in the OECD. Its $ 205 million loss in the third quarter of 1992 was the direct outcome of US consumer credit card defaults. Similarly, the last time American Express posted a loss (of $ 628.5 million in the first quarter of 1990) that arose entirely from OECD business.

### Flight Capital to the Rescue

Yet banks provide no account of what portion of the flight capital they manage actually ends up in their own deposit base. And the balance sheets of the important Swiss and English banks – which depend significantly on flight capital – contain little or no discussion of this activity. The US banks are relative newcomers to this business, having only developed it seriously in the last 20 years. But London and Zurich are very old centres of capital flight money. They do not need to advertise. National Westminister discreetly guides such clients to the international private banking business of its subsidiary Coutts and Co, headquartered at Zurich.

The Bank for International Settlements (BIS) maintains data on all deposits with BIS-reporting banks made by nationals of any country. But it does not list fiduciary assets (managed funds) or other assets such as real estate. So it is difficult to make assessments of the capital flight specific to a particular country. BIS data showed (1992), for instance, outstanding Brazilian debt at $ 61.563 billion, but deposits with BIS reporting banks at only $ 24.257 billion. Similarly, Mexican deposits are stated to be $ 27.995 billion when private Mexican funds abroad are believed to exceed $ 70 billion. BIS data excludes trust funds and the majority of assets are in such trusts.

Such capital has been significant in economies such as the US and the UK, both as a source of invisible earnings and of investment in government securities. Low taxes for non-resident investors encourage flight capitalists to take money out of heavily-indebted countries. third world flight capitalists whose countries have to reschedule their loans to US banks play the ironical role of being lenders to American banks, and to the US government, financing its budget deficit.

In both the case of the OPEC crisis and the LDC debt crisis, a perceived threat to capitalism became a significant asset. OPEC profits would, it was claimed, wreck the international financial system. Petrodollar funds flooded the banks beginning in 1974. Yet recycled, they provided the basis for great financial expansion. The same has been true of flight capital from the third world.

### Flying Dutchman

This is what I had written in a newspaper in January 1994 when reviewing a research paper produced by Barings Plc: "So now Indias foreign currency reserves and balance of payments depend critically on the perception of foreign institutional investors about this country; and how this fits into their overall logic of deploying their funds around the world." Quoting from the Barings' paper: "Two separate and parallel spheres of money exist — an industrial circuit and financial circuit... The more cash that exists in one circuit the less there is available for the other... Consequently, strong economies do not always have strong stock markets and weak economies do not always have weak stock markets: relative liquidity levels are important."

I summarised the paper as saying that: "the single most important concern in this model is global flows of liquidity. Investors should then ride the tide of liquidity flowing into one economy after another in different places in the world. And they should exit when international capital flows out...The short-term nature of such capital flows should warn Indian policy-makers. Is this a reliable source of investment that will develop Indias economy?

"..International investment has recovered from the LDC debt crisis, the leveraged buy out crisis, the consumer finance and real estate disasters. It is now trying its luck with the emerging market funds. Bad news for India."