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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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   It should be in a 8 point Calibri Font, single spaced and justified. The manuscript should preferably not exceed ***5000 WORDS***.

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PONZI SCHEMES: A FRAUDULENT BITE

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ABSTRACT

The paper deals with the origin of ponzi scheme and the factors which have been largely responsible for mushrooming of these schemes in India. The financial impact of the schemes in India has been also analyzed along with the steps taken by the regulators for controlling the illegal flow of money in hands of fraudulent companies. The effect the Prime Minister's Jan Dhan Yojna may have on reducing the siphoning of money from hands of unbanked sector of Indian society has also been discussed.

KEYWORDS
fraudulent, pyramid, consumer price inflation, SEBI, RBI, Prime Minister Jan Dhan Yojna, securities (laws) amendment ordinance.

INTRODUCTION

A **Ponzi scheme** is a fraudulent investment operation where the operator, an individual or organization, pays returns to its investors from freshly raised new capital collected by the scheme operators from the new investors, rather than from profit earned by the operator. Operators of Ponzi schemes usually entice new investors by offering higher returns than other investments, in the form of short-term returns that are unrealistic, abnormally high or fake. The scheme is named after Charles Ponzi, who became notorious for using the technique in 1920.

TEN TOP PONZI SHOCKERS

1. THE NAMESAKE

The King of Get Rich Quick, Charles Ponzi became a millionaire in six months by promising investors 50% return in 45 days on international postal coupon investments. He earned $15 million, which in 1920s terms was serious money. After Ponzi was caught, investors only received $5 million back.

2. MADMAN MADOFF

Bernard Madoff's scam is still unfolding. The facts as we know them now are that Madoff spent decades building the biggest Ponzi scheme in history, bilking nonprofits, famous people, funds, banks, and countless others out of $50 billion.

3. THE RETIREE PLUNDERER

Mexican resort owner Michael Eugene Kelly schemed retirees and senior citizens out of $428 million. He offered them timeshare investments in Cancun hotels that he called "Universal Leases." The timeshares came with rental agreements promising investors a nice fixed rate of return. Most of his victims used their retirement savings, thinking they would get solid, low-risk returns. The SEC says that "more than $136 million of the funds invested (came) from IRA accounts." Kelly, meanwhile, bought himself a private jet, racetrack, and four yachts.

4. THE BOY BAND BANDIT

Beginning in the late 1980s, Lou Pearlman, Art Garfunkel's cousin and former manager of 'N Sync and the Backstreet Boys, offered attractive returns through his FDIC-insured Trans Continental Savings Program. The scheme was neither a savings and loan nor FDIC-approved, but that didn't stop Pearlman from bilking investors out of nearly $500 million, with which he planned on funding three MTV shows and an entertainment complex.

5. THE BIBLICAL BILKER

In fraud-rich Florida, the Greater Ministries International church used Bible-speak to cheat its flock out of $500 million. Starting in the early 1990s, the church, led by gun-toting minister Gerald Payne, offered worshippers investments in gold coins. Payne then created an investment plan that would "double the 'blessings' that people invested" by funneling money towards the church's fake precious metals investments. According to the Anti-Defamation League,

Payne said that God had modernized the multiplication of the loaves and fishes and asked him to share the secret.

$500 million later, the Feds caught Payne, but most investors never got their money back.

6. THE COSTA RICA CROOKS

Three Costa Rican brothers, Enrique, Osvaldo and Freddy Villalobos, defrauded clients–mostly American and Canadian retirees–out of $400 million in a 20-odd-year unregulated loan scheme that started in the late 1980s. They promised interest rates of 3% per month on a minimum investment of $10,000. Villalobos moved money through shell companies before paying investors. Its staying power had to do with the fact that margins were low, the brothers were disciplined, and the outfit just barely skirted past laws.

7. THE LOTTERY UPRISING

When Albania was moving out from behind the Iron Curtain in the mid-1990s, a powerful government and environment of questionable ethics resulted in a financial system dominated by pyramid schemes. The government endorsed various Ponzis, which robbed the majority of the population and netted more than $1 billion in losses. Albanians rioted and overthrew the government.

8. THE SCIENTOLOGIST SNAKE

Earthlink co-founder and Scientology minister Reed Slatkin posed as a brilliant investment advisor for A-list Hollywood residents and corporate bosses. Working out of his garage, Slatkin cheated the rich and famous out of roughly $593 million, creating fake statements referring back to fake brokerage firms to prove his mettle. He fed the Church of Scientology with millions of his winnings. In 2000, the SEC caught wind that Slatkin wasn't licensed, and busted the scheme.

9. THE HAITI HATERS

Ponzi schemes popped up all over Haiti in the early 2000's. These schemes sold themselves as government-backed "cooperatives." They ran mainstream-sounding ads, some of which featured Haitian pop stars. As a result, people felt safe investing more than $240 million–60% of Haitian GDP in 2001–into the schemes, which ended up being a massive swindle.

10. THE FRAUDULENT FEMINIST

In 1880, Boston Ponzian Sarah Howe promised women 8% interest on a "Ladies Deposit." She said it was only for women, selling an implicit assumption of safety. She took the money and ran.

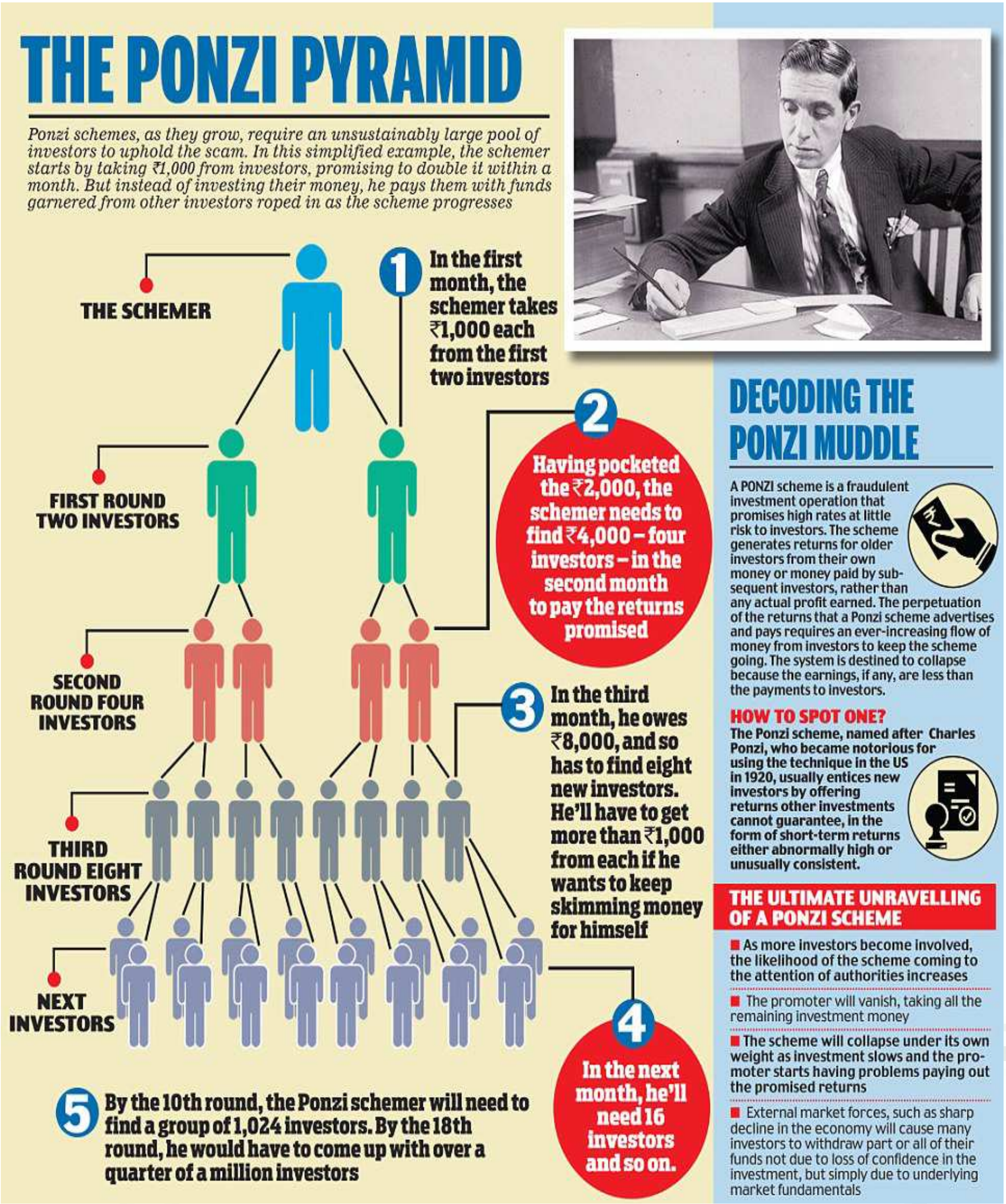
METHODOLGY

Ponzi schemes normally begin as legitimate businesses, until the business fails to achieve the returns promised. The operations turns a Ponzi scheme and it then continues under fraudulent terms. Whatever the initial situation, the commitment of the high returns propels the need for an ever-increasing flow of money from new investors to sustain the scheme.

A sample of urban middle class having gross annual income between Rs.300000 and Rs.750000 were contacted. Their saving pattern with reference to the options available to them viz. FDRS, Mutual Funds, Equity, Real Estate and Gold with reference to the ROI were examined. The survey and interaction with people revealed typically, extraordinary returns which were promised on the original investment and vague verbal constructions such as "hedge futures trading", "high-yield investment programs", or "offshore investment" were factors that attracted small and middle level investors towards these schemes.

It is noted that Initially the promoter will pay out high returns to attract more investors, and to lure current investors into putting in additional money. Other investors begin to participate, leading to a cascade effect. The "return" to the initial investors is paid out of the investments of new entrants, and not out of profits. The investors and the down the line joining appear like a pyramid. The original investor is also given an incentive in form of high bonus in cash and kind to lure further people to the net of PONZIS.

HOW THE PONZI PYRAMID WORKS



ANALYSIS AND DISCUSSION

These Ponzi schemes have managed to raise thousands of crore over the years. How do these schemes collect such large sums of money? A June 2011 report in The Economic Times had estimated that PACL had managed to collect Rs 20,000 crore ($3.30 billion) from investors at that point of time. This means that since then the company has managed to collect Rs 30,000 crore ($4.92 billion) more from investors. An April 2013 report in Mint, quoting state officials had put the total amount of money collected by Saradha group at Rs 20,000 crore ($3.30 billion). Sahara is returning more than Rs 20,000 crore ($3.30 billion) that it collected from investors over the years.

These funds often target poor, rural residents without bank accounts who have nowhere else to put their money. Many investment firms employ agents who earn commissions as high as 10 percent from their employers for collecting as little as 20 rupees (33¢) every day from rural depositors, says S. Ananth, an independent researcher based in the state of Andhra Pradesh who specializes in rural financing. “It’s a good thing SEBI has finally woken up,” he says. “These schemes have smartly tapped a population that saves through daily deposits of pygmy sums. The more under banked a region is, the more is the presence of such elements." While these ponzi schemes have been ballooning, household financial savings, or the money invested by individuals in fixed deposits, small savings scheme, mutual funds, shares, insurance etc., have actually been declining.

Since May, SEBI has cited 46 companies—including one named Weird Industries—compared with eight in the previous 12 months. The 54 companies it has cited since May 2013 have raised $10.6 billion in assets. They are instructed not to collect any money from the public or start funds until they are approved by SEBI, according to documents on the regulator's website. In the orders, SEBI makes no determination about whether the companies are legitimate—only whether they collect and pool money from the public and therefore require regulatory approval. Most of these Ponzi schemes were running what Sebi calls a collective investment scheme, though they tried to portray it as something else.

A spate of Ponzi schemes has come to light in recent years. All of them typically involve legal wrangling with regulators, public assurances by company officials that they are being unfairly targeted and every investor will get her money back, and eventually, the inevitable happens – hapless millions are parted with their life's savings.

The recent bust-ups include Sahara, Saradha Chit Fund, Rose Valley Hotels and Entertainment and most recently, PACL. In an order against PACL, the Securities and Exchange Board of India estimated that the company had managed to collect close to Rs 50,000 crore ($8.27 billion) from investors.

The latest annual report by the Reserve Bank of India points out that "the household financial saving rate remained low during 2013-14, increasing only marginally to 7.2 per cent of GDP in 2013-14 from 7.1 per cent of GDP in 2012-13 and 7.0 per cent of GDP in 2011-12...the household financial saving rate [has] dipped sharply from 12 per cent in 2009-10."

While the household financial savings have dipped, the money collected by Ponzi schemes has grown by leaps and bounds. What explains this dichotomy? Some experts have blamed the low penetration of banks as a reason behind the rapid spread of Ponzi schemes in the last few years. K C Chakrabarty, former deputy governor of the Reserve Bank of India, in September 2013 had pointed out that only 40,000 out of the 600,000 villages in India have a bank branch. Hence, investors find it easier to invest their money with Ponzi schemes, which seem to have a better geographical footprint than banks. The trouble with this reasoning is that the bank penetration in India has always been low. So, why have so many Ponzi schemes come to light only in the last few years?

Another explanation is that the rate of return promised by these Ponzi schemes is high and investor greed gets the better of them. This claim needs to be understood closely. Take the case of Rose Valley. The return on the various investment schemes run by the company varied from anywhere between 11.2% to 17.65%. PACL offered returns of 12.5-14% on investments. Saradha reportedly offered returns of 17.5-22%.

It is clear that returns promised by these Ponzi schemes have been significantly higher than the returns available on fixed income investments like fixed deposits, small savings schemes, provident funds etc., which ranged between 8-10%. The lower band of the returns offered by such schemes were not a whole lot higher than fixed income investments. Rose Valley was paying 11.2% on one of its schemes. PACL was offering 12.5%. Also, investment made in fixed income investments like public provident fund and employees provident fund qualifies for a tax deduction, thus pushing up effective return to greater than 10%.

The returns offered by the likes of Rose Valley, Saradha, Sahara and PACL are very low. But investors have still flocked to them. In fact, in its order against PACL, Sebi estimated that the company had close to 5.85 crore investors. Why, indeed, are so many people flocking to such schemes?

CONCLUSION

The answer lies in the high inflation that has prevailed in the county since 2008. For most of this period, the consumer price inflation and food inflation have been greater than 10%. In this scenario, the returns on offer on fixed income investments have been lower than the rate of inflation. Hence, people have had to look at other modes of investment, in order to protect the purchasing power of their accumulated wealth.

This explains why so much money has founds its way into Ponzi schemes, despite not offering outrageous returns. They offer returns that are higher than inflation and that is, naturally, an attractive rate of return. It is through this artificial suppression of interest rates that the government of India has contributed to the success of Ponzi schemes. Recently launched Jan Dhan Yojna of the Prime Minister is going to play a major role in busting the role of these schemes. The recently enacted the securities (laws) amendment ordinance, will empower sebi to control the proliferation and propgataion of such schemes. the key notes of the said ordinance are ;

1. With promulgation of this ordinance, India capital market regulator the Securities and Exchange Board of India (SEBI) got back the power to act against ponzi schemes, illegal deposit schemes and assess call data records in securities-related offences.
2. It provides powers for SEBI chairman to authorise Investigating Authority or any other officer of the regulator to conduct search and seizure under the Sebi Act and crack down on Ponzi schemes.
3. SEBI can regulate any money pooling scheme worth Rs. 100 crore or more and attach assets in cases of non-compliance and its Chairman can order "search and seizure operations
4. The ordinance also empowers the market watchdog to seek information, such as telephone call data records, from any persons or entities in respect to any securities transaction being investigated by it.

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