

Securities Scam Genesis, Mechanics and Impact

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Abstract

The term "securities scam" refers to a diversion of funds to the tune of over Rs. 3500 crores from the banking system to various stockbrokers in a series of transactions (primarily in Government securities) during the period April 1991 to May 1992. The scam has for several months become a permanent feature of the front pages of the newspapers. Despite the massive media coverage of the scam, most readers found it hard to understand it particularly when they were confronted with arcane terms and acronyms like ready forward, double ready forward, SGL, PDO, BR, PMS etc. Nevertheless an understanding of the scam is a prerequisite for any meaningful analysis of policy alternatives to improve the functioning of the financial system.

This paper presents a plausible reconstruction of how the scam originated, how it was perpetrated, and what would be its aftermath. The paper is expository in nature and the authors make no claims to omniscience.

The paper goes on to discuss the response of the government to the scam in terms of 1) discovering and punishing the guilty, 2) recovering the money, and 3) reforming the system. While agreeing with the importance of discovering and punishing the guilty, the paper argues that the attempt of the government to recover the money by such measures as the tainted shares law which cause severe and unjustified hardship to genuine and innocent investors is misguided.

Turning to the arena of reforms of the financial system, the paper argues that the origins of the scam lie in overregulation of our markets. It recommends that normal transactions must be allowed to be done openly and transparently, and the role of brokers as market makers must be recognized. The second lesson from the scam is that artificial insulation of closely related markets from each other is counterproductive in the long run. Artificial barriers between the money market and the capital market, between the market for corporate securities and the market for government securities and between the formal money market and the informal one must be eliminated.

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Introduction

In April 1992, the first press report appeared indicating that there was a shortfall in the Government Securities held by the State Bank of India. In a little over a month, investigations revealed that this was the just the tip of the iceberg: what came to be called the *securities scam* involved diversion of funds to the tune of over Rs. 3500 crores (well over \$ 1 billion) and covered almost all aspects of the functioning of the money market.

The scam became a permanent feature of the front pages of the newspapers with parallel investigations by the Reserve Bank of India (RBI), the Central Bureau of Investigation (CBI) and the Joint Parliamentary Committee (JPC) unearthing new aspects of the scam intermittently.

The government responded to the scam with a new law which set up a special court to try those accused in the scam. The new law also attached the property of the accused and voided all transactions done by them over the past year. These harsh and extraordinary measures created a panic in the stock markets. The scam also had an impact on the liberalization policies being pursued by the government with several reform measures being put on hold.

Despite the massive media coverage of the scam, most readers found it hard to understand it particularly when they were confronted with arcane terms and acronyms like ready forward, double ready forward, SGL, PDO, BR, PMS etc. Nevertheless an understanding of the scam is a prerequisite for any meaningful analysis of policy alternatives to improve the functioning of the financial system.

This paper presents a plausible reconstruction of how the scam originated, how it was perpetrated, and what would be its aftermath. The paper is expository in nature and is based on our analysis of the available published data as well as discussions with some participants in the securities markets. We make no claims to omniscience.

The paper then goes on to discuss the government's response to the scam and analyse the policy initiatives required.

The Two Securities Markets

The scam was in essence a diversion of funds from the banking system (in particular the inter-bank market in government securities) to

the brokers for financing their operations in the stock market. The key to understanding the scam is therefore a clear understanding of these two markets: the government securities market and the stock (corporate securities) markets. We present below a comparison of these two markets:

Characteristic	Government Securities Market	Stock Market
Securities	*Government Securities *PSU (Public Sector Undertakings) Bonds *Units of the Unit Trust of India	Corporate Securities (shares and debentures)
Size (Trading Volume)	Rs. 3000 - 4000 crores (over \$ 1 billion) a day	Rs. 50 - 200 crores (\$15 - 70 million)
Players	Banks Financial Institutions	Individuals Companies Financial Institutions
Inter-mediaries	About a dozen brokers approved by the Reserve Bank of India (RBI)	About 500 brokers in the Bombay Stock Exchange
Finance	Money Market ("Formal" market)	<i>Badla</i> Finance Market ("Informal" Money Market)
Cost of Finance	18-20%	35-40%

The crucial part of the comparison is the last element which indicates that the cost of finance in the informal money market which finance stock market operations is about twice that of the formal market in which banks lend to each other against government securities. Needless to say, restrictions of various kinds kept the two markets insulated from each other allowing this massive differential to persist. It is also quite clear that there were enormous profits to be had for anybody who could find a way of breaching the artificial wall separating the two markets and arbitrage between them. That in essence was what the scam was all about. But before we turn to that, it is necessary to take a look at the changes in the economic environment during the period of the scam. It is especially important to understand how these changes were affecting the principal players in both markets.

The government was, at the time, engaged in a process of economic liberalization under the auspices of the International Monetary

Fund. These changes promised unprecedented growth and prosperity for the private corporate sector as new sectors of the economy were thrown open to them and various administrative impediments were removed. In response to this, the stock market boomed - the Bombay Stock Exchange Sensitive Index (Sensex) rose from around 1000 in February 1991 to a peak of 4500 in March 1992 just before the scam came to light. This meant an enormous increase in the scale of finance required for those who wanted to operate in the stock market. Restrictions by the Bombay Stock Exchange on margin trading added to this funds requirement.

At the same time, the new free market philosophy confronted the public sector with new challenges. There was a tremendous pressure on the public sector to perform - to perform in financial terms. The nationalized banks were also under the same pressure to improve their bottom line. The proposed increase in capital adequacy requirement (mandated by the Narasimham Committee report) added to this pressure.

Another innovation in the banking sector in the period preceding the scam was the Portfolio Management Scheme (PMS). Under this scheme, banks could accept money from their clients to be invested on their behalf in the money market or the stock market. In theory, the clients were to get the actual return earned on these funds. In practice, however, PMS became simply a deposit which was not subject to interest rate ceilings or to reserve requirements. This situation arose because several public sector undertakings (PSUs) particularly in the oil sector had large amounts of surplus cash with them and there was an intense competition among the banks for these funds. (Some of these PSUs were encouraged to borrow in international markets to bolster the country's precarious foreign exchange reserves. Since they had no immediate need for these funds, they ended up with large cash surpluses, and since they were paying interest on these loans, they were eager to earn a decent return on them.)

Banks were thus forced to look for higher returns both to improve their own profitability and to compete for PMS funds from the PSUs. This was happening at the same time when there was a growing need for funds in the informal money market to finance stock market operations at very high rates of interest. The time was ripe for somebody to find innovative means of diverting the banks' funds to the stock market. Brokers who were operating in both markets were ideally placed to do this, and thus the scam was born.

The Ready Forward Deal

The crucial mechanism through which the scam was effected was the ready forward (RF) deal. The RF is in essence a secured short term (typically 15 day) loan from a bank to another bank. Crudely put, the bank lends against government securities just as a pawnbroker lends against jewellery.

In form, however, the RF is not a loan at all. The borrowing bank actually *sells* the securities to the lending bank and buys them back

at the end of the period of the loan at (typically) a slightly higher price. The price difference represents the interest on the loan.

The RF is what in other countries is known as repo or repurchase agreement. It is a very safe and secure form of lending and is very common throughout the world. The US repo market, for example, is about a hundred times larger than the Indian RF market.

The RF in India serves two main purposes:

- * Like repo markets around the world they provide much needed liquidity to the government securities markets.
- * They are an important tool in the hands of the banks to manage their Statutory Liquidity Ratio (SLR) requirements. Banks in India were required to maintain 38.5% (now being reduced to 30%) of their demand and time liabilities (DTL) in government securities and certain approved securities which are collectively known as SLR securities. RF helps in managing this requirement in two ways:
 - * A bank which has a temporary surge in DTL may not want to buy SLR securities outright and then sell them when the DTL comes back to normal. Instead it can do a RF deal whereby it effectively borrows the securities from a bank which has surplus SLR securities. An RF in SLR securities can thus be seen either as lending of money or as borrowing of securities.
 - * An RF deal is not legally a loan. A bank which borrows under RF does not have to treat it as a part of its liabilities at all. Since it is not a part of its DTL, it does not need to maintain an SLR in respect of this borrowing. If the bank makes an outright borrowing, it would have to maintain 38.5% of it in SLR securities.

In India, the RBI allowed banks to do RFs only in government securities and not in PSU bonds or units. As far as companies and individuals were concerned, the RBI's prohibitions did not apply. However, some provisions of the Securities Contract Regulation Act (1956) particularly sections 13, 16 and 20, prohibited forward contracts and options other than the settlement trading allowed in the stock exchanges. Legal opinion has been that this ban does not apply to securities which are not listed in the stock exchanges. Since units and most PSU bonds are not listed, companies and individuals could do RFs in these instruments.

The Mechanics of the Scam

As has been said, the RF is, in substance, a secured loan to a bank. To make the scam possible, the RF had to undergo a complete metamorphosis: it had to become an unsecured loan to a broker. How could this happen?

There were three crucial steps in this transformation:

- * The settlement process in the government securities markets had to become broker intermediated: delivery and payments had to be routed through the broker instead of being made directly between the transacting banks.
- * The broker through whom the payment passes on its way from one bank to another had to find a way of crediting this money into his account though the account payee cheque was drawn in favour of a bank.
- * While the above two steps would transform the RF from a loan to a bank into a loan to a broker, it would still be a secured loan. The broker had to find a way of persuading the lending bank to dispense with security or to accept worthless security.

We shall now examine each of these steps in turn to understand the modus operandi of the scam.

Settlement Process

The normal settlement process in government securities is that the transacting banks make payments and deliver the securities directly to each other. The broker's only function is to bring the buyer and seller together and help them negotiate the terms. He does not handle cash or securities. In this respect, the broker functions like the broker in the inter bank foreign exchange market. Closer to ordinary life, this is how the real estate broker also operates: he does not handle the money or the title deeds which are exchanged directly between buyer and seller.

During the scam, however, the banks or at least some banks adopted the alternative settlement process of making delivery and payment through the broker. That is to say, the seller hands over the securities to the broker who passes them on to the buyer. Similarly, the buyer gives the cheque to the broker who then hands it over to the seller. This settlement process is similar to what obtains in the stock market where in fact the buyer and the seller may not even know whom they have traded with: both know only the broker.

There were two important reasons why the broker intermediated settlement began to be used in the government securities markets:

- * The brokers instead of merely bringing buyers and sellers together started taking positions in the market. In other words, they started trading on their own account, and in a sense became market makers in some securities. Brokers taking positions has its advantages: it adds liquidity to the market. But the fact that brokers were doing so was not openly recognized, and brokers adopted the subterfuge of pretending to act on behalf of a bank. Some banks allowed their name to be used in this manner where a transaction

which is actually on the broker's personal account is routed through the bank.

- * When a bank wanted to conceal the fact that it is doing an RF, the broker came in handy. The second leg of the RF would be made out to be with a different bank so that at first glance it does not appear as if a RF has been done. On paper, it appears as if an independent purchase and an independent sale transaction have been done with two different parties. The broker provided contract notes for this purpose with fictitious counterparties, but arranged for the actual settlement to take place with the correct counterparty.

Account Payee Cheques

Broker intermediated settlements allowed the broker to lay his hands on the cheque as it went from one bank to another. The problem was now to credit it to his account though it was drawn in favour of the bank and was crossed account payee.

The account payee crossing is purely a matter of banking custom. As a matter of custom banks pay these cheques only to the payee mentioned on the cheque, but there is nothing in the Negotiable Instruments Act which mandates this practice. As a matter of banking custom, exceptions were being made to this practice long before the scam. Privileged (corporate) customers were routinely allowed to credit account payee cheques in favour of the bank into their own account. Why was this done?

The emergence of this exception to normal practice can be attributed to clearing delays. Normally, if a customer obtains a cheque in his own favour and deposits it into his own account, it may take a day or two for the cheque to be cleared and for the funds to become available to the customer. On large amounts, the interest loss implicit in this clearing delay is substantial. At 15% interest, the interest loss on a clearing delay of two days for a Rs. 100 crore cheque is Rs. 8 lacs. Obviously, customers were on the lookout for ways of eliminating this clearing delay.

The route which was available was the cheque drawn by a bank on its account with the RBI. The RBI acts as the bankers' banker, and banks make payments to each other by writing cheques on their account with the RBI. These cheques are cleared on the same day: RBI, after all, has only a few customers' accounts to maintain. The practice which thus emerged was that a customer would obtain a cheque drawn on the RBI favouring not the customer himself but his bank. The bank would get the money the same day and credit its customer. This was the practice which the brokers in the money market exploited to their benefit.

Normally in this system, the issuing bank writes a covering letter to the payee bank instructing the latter to credit the account of the customer. In the case of the brokers during the scam, this precaution was also dispensed with. Since everybody knew that

brokers were taking positions on their own account, it was but natural that they would receive payments on their own account, and the banks asked no questions about the enormous sums that were credited and debited into the brokers' personal accounts.

Dispensing with the Security

The broker having found a way of getting hold of the cheque as it went from one bank to another and crediting it to his account effectively transformed the RF into a loan to himself rather than to a bank. But this, by itself, would not have led to the scam for the RF is a secured loan, and a secured loan to a broker is still secured. What was necessary was to find a way of eliminating the security.

Three routes were adopted for this purpose:

- * Some banks (or rather their officials) were persuaded to part with the cheque without actually getting the securities in return. The simplest explanation of this is that the officials concerned were bribed and/or negligent. The more intriguing possibility is that the banks' senior/top management were aware of this and turned a blind eye to it. One must recognize that as long as the scam lasted, the banks also benefited from it in the form of the higher returns that the brokers could offer for funds diverted to the stock market. A bank might have been sorely tempted to adopt this route to higher profitability. This method accounted for slightly less than half of the total amount of the scam.
- * The second route was to replace the actual securities by a worthless piece of paper - the fake Bank Receipt (BR). This method accounted for a little more than half of the total amount of the scam. This is discussed in greater detail below.
- * The third method was simply to forge the securities themselves. In many cases, PSU bonds were represented by allotment letters rather than certificates on security paper. It was probably easier to forge an allotment letter for Rs. 100 crores than it was to forge a 100 rupee note. However, outright forgery accounted for only a very small part of the scam.

Bank Receipt

More than half of the amount involved in the scam was obtained from the banks against worthless (fake) Bank Receipts (BRs). In an RF deal, as we have discussed it so far, the borrowing bank delivers the actual securities to the lender and takes them back on repayment of the loan. In practice, however, this is not usually done. Instead the borrower gives a BR which serves three functions:

- * The BR confirms the sale of securities.

- * It acts as a receipt for the money received by the selling bank. Hence the name - bank receipt.
- * It promises to deliver the securities to the buyer. It also states that in the meantime the seller holds the securities in trust for the buyer.

In short, the BR is something like an IOU (I owe you securities!), and the use of the BR makes the RF an unsecured loan in fact. The lending bank no longer has the securities; it has only the borrower's assurance that it has the securities and will deliver them when the need arises.

Advantages of using BRs

There were several reasons why BRs came to be used in lieu of the actual securities:

- * BRs were very convenient for RFs because delivery need never be made. BRs can be simply cancelled and returned when the RF is reversed.
- * In case of PSU bonds, actual delivery was very difficult for a variety of reasons:
- * The volume of scrips to be delivered is very large when RFs are made for hundreds of crores.
- * In a number of cases, the PSUs had not issued the bond certificates for long periods, and the holding of these PSUs was evidence only by an allotment letter.
- * Sometimes, the bond certificate was issued in very large denomination (often one certificate for the entire holding) and delivery was very difficult when an RF was done for a part of this holding.
- * The process of transferring PSU bonds was quite time consuming.
- * In case of government securities, the RBI had issued a directive that BRs should not be used. The reason was that, for these securities, the RBI, through its Public Debt Office (PDO), acted as the custodian. Physical securities are never issued, and the holding of these securities is represented by book entries in the PDO. The ledger in which the PDO maintains these accounts is called the Subsidiary General Ledger (SGL), and these securities are referred to as SGL securities. When a holder of these securities sells them and wishes to transfer them to the buyer, he fills up a SGL transfer form and gives it to the buyer. This SGL form can be compared to a cheque: the buyer deposits it into his SGL account at the PDO, and the PDO makes a book entry reducing the holding of the seller and increasing that of the buyer.

Because of this facility, the RBI thought that BRs are not needed in these securities. If the PDO functioned efficiently and carried out its bookkeeping in a timely manner, this would have been quite a correct assumption to make. Unfortunately, the PDO was very inefficient and lagged in its functioning. This was a very serious matter because, like a cheque, an SGL form can also bounce if the seller does not have sufficient holding of securities in his SGL account. The buyer needs to be informed about this promptly; else, he may resell the securities by issuing his own SGL forms in the belief that he has sufficient balance in his account. The inefficiency of the PDO made the SGL form an inconvenient and unreliable instrument, and banks preferred to use BRs for the SGL securities also in violation of the RBI's directive.

IBA's Bank Receipt Rules

The Indian Banks Association (IBA) formulated a set of rules to regulate the use of BRs. The principal rules were as follows:

- * BRs must be issued only in the prescribed form, must be on security paper, and must be serially numbered.
- * BR is non-transferable.
- * BR must be signed by two authorized signatories whose signatures should be registered with the buying bank to verify the signatures.

None of these rules were seriously adhered to.

BRs Issued without Backing

As stated earlier, the BR is supposed to imply that the issuer actually has the securities and holds them in trust for the buyer. But in reality the issuer may not have the securities at all. There are two reasons why a bank may issue a BR which is not backed by actual securities:

- * The bank may want to shortsell the securities. In other words, the bank thinking that the securities are going to fall in value sells securities which it does not have. It does an outright sale (not an RF!) and instead of delivering the actual securities, issues a BR. When the securities fall in value, the bank buys them at the low price and discharges the BR by delivering these securities. Short selling in some form or other is an integral part of most bond markets in the world. It can be argued that some amount of shortselling subject to some degree of regulation is a desirable feature of a bond market. In India, the only way to shortsell was to issue a BR without the backing of the securities. In our opinion, an outright sale using a BR which is not backed by securities is not harmful per se though it violates the RBI guidelines.

* The second reason is that the bank may simply want an unsecured loan. It may then do an RF deal issuing a BR without any securities to back them. The lending bank would be under the mistaken impression that it is making a secured loan when it is making a totally unsecured loan. This kind of a BR which has no backing is referred to as a fake BR; it is quite clear that an RF borrowing on the basis of a fake BR is nothing short of cheating.

In a situation where most RF deals were being done using BRs, any lending bank should have known that it may be taken for a ride by a borrower issuing a fake BR. Obviously, lenders should have taken care to protect themselves from such a possibility. This aspect will be examined later when we discuss the banks' control system in general and counterparty limits in particular.

During the scam, the brokers perfected the art of using fake BRs to obtain unsecured loans from the banking system. They persuaded some small and little known banks - the Bank of Karad (BOK) and the Metropolitan Cooperative Bank (MCB) - to issue BRs as and when required. These BRs could then be used to do RF deals with other banks. The cheques in favour of BOK were, of course, credited into the brokers' account. In effect, several large banks made huge unsecured loans to the BOK/MCB which in turn made the money available to the brokers.

Magnitude & Breakup of the Scam

At this stage, it is useful to provide a summary picture of the magnitude of the scam and its breakup in terms of banks, brokers and modus operandi employed. The Janakiraman Committee put the total exposure of the banking system at Rs. 3542 crores.

Out of this, Rs. 1439 crores was accounted for by Shri Harshad Mehta whose modus operandi involved loans without any security. The breakup of this amount is as follows

From National Housing Bank	
via State Bank of India (SBI)	708
via ANZ Grindlays Bank	506
via Standard Chartered Bank	55
via Canfina (under investigation)	2
	1271
From State Bank of Saurashtra	
via SBI and NHB	175
From SBI Capital Markets Ltd	121
Total	1567

Most of the remaining amounts represent borrowings from Standard Chartered Bank and others against fake BRs of the Bank of Karad

(BOK) and the Metropolitan Cooperative Bank (MCB). A large part of this money has been traced to A.D. Narottam's account in the BOK and to Shri Hiten Dalal's account in Andhra Bank and it is very likely that the rest of the money also ended up in their hands. These two brokers appear to have acted in concert with one of them often making payments for purchases made by the other. The aggregate amount involved in this part of the scam appears to be Rs. 1870 crores:

From Canfina against BOK's BR	435	
From Canbank Mutual fund against BOK's BR	103	
From Standard Chartered Bank against BOK's BR	356	
against MCB's BR	576	932
Total amount against fake BRs		1470
From Standard Chartered Bank without any security		400
Total		1870

The remaining amount of Rs. 105 crores represents the amount borrowed by Fairgrowth Financial Services Ltd. (FGFSL) from Andhra Bank Financial Services Ltd (ABFSL) against forged securities. (The total amount of forged certificates was originally Rs. 206 crores, but ABFSL subsequently obtained fresh securities from FGFSL for Rs. 101 crores.)

In short, the beneficiaries of the scam were:

Harshad Mehta	1567
Narottam/Hiten Dalal	1870
Fairgrowth	105

Total	3542
	=====

The bankwise exposure was:

Standard Chartered Bank	1332
National Housing Bank	1271
Canara Bank group	538
State Bank group	296
Andhra Bank group	105

Total	3542
	=====

Control Systems

The scam was made possible by a breakdown both of the control system within the banks and of the control system of the RBI itself.

The internal control system within the banks involves several features:

- * Separation of functions: The idea is that different aspects of the securities transactions of the banks are carried out by different persons. Ideally, this means a separation of dealing, custody and accounting. Dealing refers to deciding which transactions to enter into with which parties. Custody involves physical custody of the securities as well as delivery and payment. Accounting is responsible for maintaining the investment account of the bank and its reconciliation with the SGL account of the PDO.

Closely related to separation of functions is the notion of double custody. Just as the currency chests in the banks are under double custody where two people have to join together to open it, the custody of securities could be under double custody.

In many banks like the National Housing Bank, these controls did not exist. In others, like the State Bank of India, they existed but broke down partially or wholly because of the negligence of one or more functionaries.

- * Counterparty Limits: The moment RFs are done on the basis of BRs rather than actual securities, the lending bank must worry about the possibility that the BR that it has received is not backed by any securities. In effect, it may be making an unsecured loan, and it must do the RF only if it would be prepared to make an unsecured loan. This means assessing the creditworthiness of the borrower and assigning him a "credit limit" upto which one is prepared to lend. Technically this is known as a counterparty limit. Strictly, a counterparty limit is required even if the RF is done against actual securities because the securities may decline in value and the RF may end up becoming only partly secured though it was fully secured to begin with.

Most of the foreign banks with the exception of the Standard Chartered Bank had very strict counterparty limits and were thus protected from lending too much against fake BRs. For a bank like the Bank of Karad, a reasonable counterparty limit may be have Rs. 50 lacs so that an RF for several hundred crores would be flatly refused. The Standard Chartered Bank either did not have or did not adhere to such limits and agreed to do these RFs.

The control system of the RBI should have involved two things:

- * A reconciliation of the SGL securities claimed by the banks in the aggregate with their total holding as revealed by the SGL accounts at the PDO. If all BRs are backed by securities, this would tally because a sale through BR would reduce the seller's investment account and increase the buyer's leaving the total unchanged.

This exercise does not seem to have been attempted at all.

- * Site inspections and other audits of the investment accounts of the banks. These were not quite comprehensive and even when some irregularities were detected, they were not taken sufficiently seriously.

Other Aspects of the Scam

What we have described above covers the bulk of the scam by magnitude. There are, however, several aspects of the scam which are closely related to the activities in the securities markets, but whose nature is slightly different. We discuss these below.

Coupon Changes and Insider Trading

During the period from September 1991 to June 1992, the government raised the interest (coupon) rate on its fresh borrowings three times; the coupon rate went up from 11.5% to 13% during this period. The natural implication of this rise in interest rates is a fall in the market prices of the old loans which are pegged at the old interest rate. This phenomenon can be observed in the price of the 11.5% Government Loan 2010. The first coupon hike from 11.5% to 12% saw the 2010 decline from 101.20 to 98.20 (RBI selling rate) - a fall of almost 3%. The second coupon hike to 12.5% caused a further 4.5% fall in price to 93.75. The third coupon hike to 13% was followed by another 3% fall in the market prices.

It is very clear that anybody who came to know of the coupon change beforehand could make an enormous amount of money by shortselling the government securities just before the hike and covering his position after the prices have fallen. Somebody who took a short position of Rs. 500 crores before the coupon hike of September 1991 could have made a profit of Rs. 15 crores in a month's time. Since several people in the ministry and the RBI are likely to be aware of the impending coupon hike, the chance of leakage of this information is always there.

Well before the scam broke out, there were news reports that suggested that some such activity might have taken place. A cover story in *Business India* in February, 1992 quoted Harshad Mehta as saying that he withdrew from the market six months earlier (i.e. in August 1991) when he realized that the interest rates were going up. He is further quoted as having claimed that he even sold securities short to profit from price falls. Of course, it can be always argued that the position was taken on the basis not of inside information but of intelligent forecasts and analysis.

In March 1992, the State Bank of India bought a huge amount of 11.5% Government Loan 2010 from Harshad Mehta on ready forward basis *one day before* the coupon hike. In fact, it was in the course of investigating this transaction that the whole scam came to light (at least that is what the RBI claims). Of course, a ready forward purchase does not imply a loss to SBI as the deal would be reversed

and SBI would get rid of the securities. But the real objective of the transaction could have been to help Harshad Mehta to shortsell the securities. We have already seen that an RF purchase can be regarded as borrowing securities. Effectively, therefore, Harshad Mehta may have been borrowing the securities (in the name of the State Bank of India) from another bank and selling the borrowed securities to a third bank. Selling borrowed securities is one way of doing a shortsale.

However, it will probably be very difficult to prove with any degree of certainty that there was insider trading on the basis of coupon rate changes. One reason is the very size of the market. With a daily trading volume of Rs. 3000 - 4000 crores, it would have been very easy for anyone to take a position of Rs. 500 or even Rs. 1000 crores without anybody suspecting anything untoward.

Window Dressing Bank Balance Sheets

Most banks carry investments in their books at their cost of acquisition and do not mark it down to market. This creates serious distortions during a period when, as shown in the preceding section, the prices of securities are falling. If one assumes that prices of government securities have fallen by an average of about 5% over the last year, then on an aggregate holding of these securities by the banking system of Rs. 70,000 crores, the paper loss would be Rs. 3,500 crores. A 10% fall in the prices of PSU bonds would imply a further paper loss of a several hundred crores. Under the current system of accounting, these losses have to be recognized only when the securities are sold.

This means that a bank would be reluctant to sell these securities and how the loss in its books. It was in this context that the banks and the brokers resorted to various methods of window dressing the bank balance sheet. The basic idea is that:

- a) The bank sells the securities to a broker at face value or at cost though they are worth much less in the market. The broker absorbs a huge loss in this transaction as he will have to resell the securities to some other bank at market prices.
- b) The bank buys some other securities from the broker at prices well above market prices. The broker makes a huge profit which compensates him for the loss which he sustained in transaction (a).

The key idea is that the loss that the bank makes in transaction (b) is not reflected in its profit and loss account at all. The securities simply appear in its balance sheet at an inflated value.

This idea can also be extended not merely to avoiding losses but also to creating profits. The transaction in (a) can be done not at original cost but at a profit. As far the broker is concerned, the price in transaction (a) can be as high as the bank wants so long as he gets a correspondingly higher price in transaction (b).

What the scam investigations have revealed is that window dressing of this kind was rampant. Instances have been recorded of the same broker selling the same security on the same day to different banks at vastly different prices. This makes it very difficult to fathom individual transactions in isolation. Unless one can put together the entire series of transactions, it is impossible to know whether the banks or the brokers have been the net gainers overall. It is conceivable that some brokers were willing to absorb part of the losses as a quid pro quo for other "services" which the banks provided them.

It is interesting to note that even the pure RF deal involves an element of window dressing. The lending bank shows the interest received as an income in its profit and loss account. But the borrowing bank does not show the interest paid as an expense. ; it simply carries the investment in its books at the higher repurchase price.

It is, in fact, quite likely that the enormous increases in the profits that some of the banks reported in the last year might have its origins in such "creative" accounting practices.

Fairgrowth Financial Services Ltd. (FGFSL)

FGFSL's role in the scam is one of the most difficult to unravel. It is necessary to distinguish several facets of FGFSL's involvement:

- * During the scam, FGFSL was involved in every aspect of the money market. It was dealing with both the Harshad Mehta group and the Hiten Dalal/ Narottam group of brokers. It was also trading heavily in the stock market - its transactions in one year amounted to Rs. 10,000 crores (?). As against a paid up capital of only Rs. crores, FGFSL had borrowings of Rs. crores and made profits of Rs. crores.
- * In the aftermath of the scam, FGFSL found itself under severe pressure to repay its debts to various banks. In the depressed conditions, it could not sell its stock market investments and honour its commitments. It was then that FGFSL resorted to outright forgery. Allotment letters of units were simply forged and delivered to the banks to whom FGFSL had sold the units.
- * Several questions have been raised about the private placement of FGFSL shares against the promoters' quota (?). The company has not yet made a public issue, but in the grey market, the shares were at one time quoting at 30-35 times the face value. In this situation, the investigating authorities seem to be acting on the assumption that anybody holding shares in FGFSL is linked to the company management and is responsible for the malpractices of the company. While such an assumption would be clearly untenable and

incorrect, the real nature of the links between the company and its shareholders is extremely murky.

Call Money Irregularities

Investigations have revealed that certain transactions in which banks purportedly lent to other banks in the call market for one or two days were in fact diverted to the brokers. This, however, appears to be relatively a small magnitude. Clearly the extremely short duration of the call market borrowings made them unattractive from the brokers' point of view.

Sale of PSU Shares

The government invited bids for purchase of the shares of some PSUs in February 1992. (This was the second instalment of PSU equity sale, the first having been done in December 1991). The offer was made to the public sector mutual funds, banks and financial institutions, and it was a condition of this sale that the institutions could offload the shares only through normal stock exchange transactions after the shares have been listed in the stock markets. In the course of the investigations it turned out that in some cases the banks acted only as conduits for making the bids: there was a prior arrangement to sell the shares to certain brokers.

The existence of such a phenomenon and of clandestine sale of PSU shares was well known even before the scam broke out. The scam investigations have only provided detailed evidence for this. The whole episode has only pointed out the utter folly of selling PSU shares to banks and financial institutions rather than to the general public as was done in the privatization campaign in Britain.

Detection of the Scam

As stated earlier, the RBI claims that the scam was detected in pursuance of its investigation of the possibility of insider trading in government securities around the coupon hike of March 1992. The RBI asked the State Bank of India (SBI) to give a list of its holdings of its securities as on March 31, 1992. SBI, therefore, had to reconcile its investment account with the SGL balances reported by the PDO. For example, in the 11.5% Government Loan 2010, the SGL balance seemed to be Rs. 1671 crores as against the balance of Rs. 1745 crores as per SBI's books. While trying to reconcile this discrepancy of Rs. 74 crores, SBI discovered that the SGL balance of Rs. 1671 crores contained an alteration: the original figures received from the PDO was Rs. 1171 crores, and it had been altered to Rs. 1671 crores. Suddenly the discrepancy became Rs. 574 crores. This represented transactions with Harshad Mehta for which neither securities nor BRs had been delivered by SBI. Finally, it turned out that an amount of Rs. 649 crores was due from Harshad Mehta. SBI promptly summoned Mehta and asked him to deliver the securities or to pay the money. Mehta offered to pay the money and between April 13, 1992 and April 24, 1992, paid an aggregate amount of Rs. 622 crores to SBI.

However, all that Harshad Mehta had done was to "borrow" the money from the National Housing Bank (NHB) in the same way that he had been borrowing from SBI and NHB earlier. This left NHB with a total exposure of over Rs. 1200 crores representing an earlier exposure of over Rs. 700 crores and a fresh exposure of Rs. 500 crores. NHB, backed by the RBI has succeeded in recovering most of the money from the banks (SBI and ANZ Grindlays) to whom NHB had issued the cheques which the payee banks credited to Harshad Mehta's account.

Where did the money go?

The billion dollar question is where did all the money go? It is difficult to say anything with certainty, but the following appear to be the important possibilities:

- * A large amount of the money was invested in shares. Harshad Mehta was known to be a "bull" operator and was continuously buying shares. The first question is what are the shares worth? Till February 1992, the Bombay Sensitive Index was below 2000; thereafter it rose sharply to peak at 4500. In the aftermath of the scam it fell to about 2500 before recovering to around 3000 by August 1992. It is very likely that the bulk of Harshad Mehta's purchases were made at low prices, so that his average cost of his portfolio corresponds to an index well below 2500 or even below 2000. Therefore, Mehta's claim that he can clear all his dues if he were allowed to do so cannot be dismissed out of hand. The second question is whether all these shares can be traced. The scam ordinance notwithstanding, there is considerable uncertainty about this because a share with a blank transfer deed is virtually a bearer instrument.
- * Considerable part of the money could have been spent on financing the stock markets losses of the Hiten Dalal/Narottam group who were known to be bear operators and were suffering heavy losses in March/ April 1992.
- * It is rumoured that part of the money was sent out of India through the havala racket, converted into dollars, and brought back as India Development Bonds. These bonds are redeemable in dollars and the holder cannot be asked to identify the source of his holdings. Thus this money is beyond the reach of any of the investigating agencies.
- * Some part must have been spent as bribes and kickbacks to the various accomplices in the banks and possibly in the bureaucracy and the political system.
- * As stated earlier, some part might represented losses taken by the brokers to window dress the bank's balance sheet. In other words, part of the money that went pout of the banking system cam back to it.

Impact of the Scam

Stock Market

The immediate impact of the scam was a sharp fall in the share prices. The index fell from 4500 to 2500 representing a paper loss of Rs. 1.0 lac crores.

The reason for this fall was not probably the withdrawal of the scam finance. On a market capitalization of Rs. 2.5 lac crores, scam finance of Rs. 3,500 crores could not have had such a drastic impact. The more likely reason for the sharp fall was the government's knee jerk response to the scam in promulgating the Special Courts Ordinance with several draconian provisions.

The ordinance attached the property of all the scam accused and also voided all transactions undertaken by them over the past one year. Since the accused were active brokers in the stock markets, the number of shares which had passed through their hands at some time within the last one year was colossal. All these shares became "tainted" shares, and a genuine investor who had bought these shares well before the scam broke out and even got them registered in his name found himself being robbed of those shares. The result was a total panic in the stock markets. The "tainted" shares, more than the scam itself was possibly the main reason for the steep fall in the market.

Liberalization

There is a general perception that in the aftermath of the scam, the liberalization policies of the government were put on hold. The Stock Exchange Board of India (SEBI) postponed sanctioning of private sector mutual funds. Implementation of some aspects of the Narasimham Committee were also probably delayed. Some question marks arose regarding privatization as the chairman of the committee looking into this ended up in jail on charges of involvement in the scam.

The much talked about entry of foreign pension funds and mutual funds became more remote than ever. The ability of Indian companies to raise equity capital in world markets was also severely compromised.

Policy Responses Required

The response of any government to a scam of this kind would have three main facets:

1. Discover and punish the guilty. This task has been entrusted to the Central Bureau of Investigation (CBI) and to the Joint Parliamentary Committee (JPC). A special court has also been set up to facilitate speedy trial.

2. Recover the money. The draconian provisions of the Ordinance for attachment of property and voiding of transactions with the consequent creation of "tainted" shares were attempts in this direction.
3. Reform the system. The government's response so far has consisted of measures like banning of RF deals and going slow on liberalization.

There cannot be any two opinions about the need for the first process of discovering and punishing the guilty. The principal objective behind punishing the offenders is more to deter future offenders. Investigations of this kind are necessarily time consuming and expensive, but they have to be gone through so that the credibility of the system is restored. A rule of thumb which is often quoted throughout the world is that investigation of any fraud will cost as much as the magnitude of the fraud itself. One can, therefore, expect the real costs of the scam investigation to be of the order of a couple of thousand crores.

The emphasis placed on the recovery of the money is, in our opinion, totally misplaced. Governments have, at all times, claimed special powers to recover its dues like land revenue and taxes. That principle does not and cannot extend to the recovery of amounts which the government owned organizations (or for that matter, the foreign banks) have lost by their own negligence or complicity. There can be no justification for such measures as the "tainted" shares law which harass genuine innocent investors in order to recover a few hundred crores.

The most constructive response to the scam would be in the arena of reforms of the financial system. In our view, the origins of the scam lie in overregulation of our markets. The regulations in the money markets were such that thoroughly legitimate and essential transactions could not be put through openly, but had to be disguised and camouflaged. The role of the brokers and of some of the banks as market makers was not recognized and they could perform these important and useful functions only by subterfuge. The payment and clearance system was so antiquated and cumbersome that totally indefensible methods had to be adopted to achieve speedy funds transfers. The net result of all this was a total lack of transparency in the operations in the money market. Irregularities of all kinds were so common that no suspicions are aroused even by highly irregular transactions. This is the ideal environment for a scam to germinate and grow to alarming proportions. We would even argue that some of the control systems in the banks broke down because they had been deliberately allowed to weaken in order to facilitate normal transactions in violation of the RBI guidelines.

The second lesson from the scam is that artificial insulation of closely related markets from each other is counterproductive in the long run. Just as water finds its own level, money also seeks out the highest levels of return after due adjustments for risk and liquidity. Even after ten years of progressive liberalization of our financial markets, artificial barriers exist between the money

market and the capital market, between the market for corporate securities and the market for government securities and between the formal money market and the informal one. Integration of these markets with the attendant equalization of returns in these markets is, in our view, a matter of the highest priority in the agenda for financial reforms. This integration will allow a coherent yield curve to emerge covering the entire financial markets.

In this context, the policy responses of the government in the direction of further regulation and controls (for example, the ban on RFs) would appear to be quite misguided. The recommendations of the Nadkarni Committee that RFs be permitted and that the entire settlement and clearing system be streamlined and computerized is to be welcomed.