

# Harshad mehta story essay sample

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Good morning to one & all my name is Vishal Oberoi & my roll no is 54. We are here to give you a presentation on scams. More specifically the securities scam of 1991-92. I would first like to introduce to you our group members they are 1) Kapil Jagasia. Roll no 13 2) Kevin Dason roll no 19 3) Ateesh Naik roll no 28 4) Mustaanseer Vora roll no 48 5) Giriraj C Iyer roll no 49 & myself Vishal Oberoi roll no 54. I would now like to call upon you to give us a brief introduction on scams. Introduction to scams

Various scams, scandals and stigmas that have surfaced in the recent years. These may not all be attributable to the antics and bungling of politicians, but they have been facilitated largely because of the vitiated atmosphere that the politicians and the political system have created in the country. Scams and scandals have manifested themselves in large numbers over the past few years. The latest, the Petrol Pump Scam concerning 3, 158 allotments of petrol pumps, LPG agencies and kerosene oil depots that were allegedly handed out on payment ranging from Rs 30 -50 lakh to Rs 2, 500 crore. The Prime Minister took the bold and welcome step of canceling these allotments. Most of the scams that have taken place keep featuring off and on in the media, but that doesn't stop the next one from taking place since investigations and trials are excruciatingly prolonged. The Bofors scam, in which Rajiv Gandhi was also named, involved the purchase of important defence equipment from foreign markets causing embezzlement of Rs 65 crore.

That was 15 years ago. Gandhi was assassinated, former Bofors agent Win Chaddha and former defence secretary S K Bhatnagar have died and we still haven't managed to extradite the main accused, Ottavio Quattarocchi and

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Martin Abdo. Likewise, the Rs 1, 200-crore fodder scam, relating to the procurement of non-existent fodder on payments from the state exchequer, has been in the news for years. Investigations revealed that the former chief minister Laloo Prasad Yadav was alleged to have drawn Rs 1, 000 crore from different government treasuries through Animal Husbandry Officers. The CBI filed 50 regular cases in courts connected with this scam, but a final decision is still awaited. In Uttar Pradesh purchases, the purchase of ayurvedic medicines worth Rs 63 crore was found to be bogus. Then, there was the securities scam involving crores of rupees in broker Harshad Mehta secured huge amounts of loans from banks against fraudulent securities. Nothing is yet evident as to what is happening to this case.

And, the telecom scam, involving the perpetrations of former Union Communications minister Sukh Ram from whose house wads of currency notes were recovered from suitcases and bags. The minister was eventually sentenced by the court to imprisonment but the sentence has been kept in abeyance on the plea that the Minister wishes to appeal against the sentence. Some of the recent scams have involved huge frauds and a large number of people. Take the scam in printing and selling stamp paper, which is used for recording documents for registration purposes. This scam is of about Rs 2, 200 crore and involves fraudulent printing and sale of stamp papers in various parts of the country. Another scam is of the fraudulent withdrawal of money, estimated to be about Rs 20 crore, for giving scholarships to scheduled caste students under false names. The list is never ending & the additions have not yet been completed there are continuous additions to it. This was a brief introduction of the various scams in India now

I would like to call upon to give u a brief introduction of the securities scam more famously known as the harshad mehta scam.

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.

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 just the tip of an iceberg which came to be called the securities scam, involving misappropriation of funds to the tune of over Rs. 3500 crores ( about \$ 1. 2 billion). In an ever expanding ambit, the scam has engulfed top executives of large nationalized banks, foreign banks and financial institutions, brokers, bureaucrats and politicians. The functioning of the money market and the stock market has been thrown in disarray. The scam has generated such immense public interest that it has become a permanent feature on the front pages of newspapers. A large number of agencies, namely, the Reserve Bank of India (RBI), the Central Bureau of Investigation (CBI), the Income Tax Department, the Directorate of Enforcement and the Joint Parliamentary Committee (JPC) are currently investigating various aspects of the scam.

## 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 brokers for financing their operations in the stock market. A clear understanding of the government securities market and the stock (corporate securities) markets is a prerequisite for understanding the scam.

## Liberalization of the Economy

After assuming office in June 1991, the new government accelerated the process of economic liberalization under the auspices of the International Monetary Fund (IMF). The opening up of the Indian economy as a result of these measures promised an unprecedented growth and prosperity for the private corporate sector as new sectors of the economy were being allowed private participation and various administrative impediments were being removed. Anticipating the good tidings for the private sector, the stock market started booming - 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 by operators in the stock market. Heavy margins imposed by the Bombay Stock Exchange on settlement trading added to the funds requirement. Even the PSUs were under pressure to perform including the nationalized banks. This was the time Harshad Mehta and his associates decided to strike.

## 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 one bank to another bank. The lending is done against government securities, exactly the way a pawnbroker lends against jewellery or other valuables. In form, however, the RF is not a loan at all. The borrowing bank (Bank 2) actually sells the securities to the lending bank (Bank 1) 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 Mechanics of the Scam

As explained above, a ready forward deal is, in substance, a secured loan from one bank to another. To make the scam possible, the RF had to undergo a complete metamorphosis: it had to become an unsecured loan to a broker. How was this transformation brought about? The three crucial steps to effect the metamorphosis were:

- The settlement process in the government securities market became broker intermediated, that is, delivery and payments started getting routed through a broker instead of being made directly between the transacting banks.
- The broker through whom the payment passed on its way from one bank to another found a way of crediting the money into his account though the account payee cheque was drawn in favour of a bank.
- While the above two steps transformed an RF deal from a loan to a bank into a loan to a

broker, it would still be a secured loan. However, the brokers soon found a way of persuading the lending bank to dispense with security for the loan or to accept worthless security. We shall now elaborate on each of these steps, in order to clearly understand the modus operandi used in 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, for which he earns a commission from both the parties. He does not handle either the cash or the securities. During the scam, however, the banks or at least some banks adopted an alternative settlement process which was similar to the process used for settling transactions in the stock market. In this settlement process, deliveries of securities and payments are made through the broker. That is, the seller hands over the securities to the broker who passes them on to the buyer, while the buyer gives the cheque to the broker who then makes the payment to the seller.

In this settlement process, the buyer and the seller may not even know whom they have traded with, both being known only to 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 thereby imparting greater

liquidity to the markets. • When a bank wanted to conceal the fact that it was doing an RF deal, the broker came in handy. The broker provided contract notes for this purpose with fictitious counter parties, but arranged for the actual settlement to take place with the correct counter party.

### Account Payee Cheques

A broker intermediated settlement allowed the broker to lay his hands on the cheque as it went from one bank to another through him. The hurdle now was to find a way of crediting the cheque to his account though it was drawn in favour of a bank and was crossed account payee. As it happens, it is purely a matter of banking custom, that an account payee cheque is paid only to the payee mentioned on the cheque. In fact, exceptions were being made to this norm, well before the scam came to light. Privileged (corporate) customers were routinely allowed to credit account payee cheques in favour of a bank into their own accounts to avoid clearing delays, thereby reducing the interest lost on the amount. 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. At 15% interest, the interest loss on a clearing delay of two days for a Rs. 100 crore cheque is about Rs. 8 lacs. On the other hand, when banks make payments to each other by writing cheques on their account with the RBI, these cheques are cleared on the same day. The practice which thus emerged was that a customer would obtain a cheque drawn on the RBI favouring not himself but his bank. The bank would get the money and credit



his account the same day. This was the practice which the brokers in the money market exploited to their benefit.

### Dispensing with the Security

The brokers thus found a way of getting hold of the cheques as they went from one bank to another and crediting the amounts to their accounts. This effectively transformed an RF into a loan to a broker rather than to a bank. But this, by itself, would not have led to the scam because the RF after all is a secured loan, and a secured loan to a broker is still secured. What was necessary now was to find a way of eliminating the security itself! Three routes adopted for this purpose were:

- Some banks (or rather their officials) were persuaded to part with cheques without actually receiving securities in return. A simple explanation of this is that the officials concerned were bribed and/or negligent. A more intriguing possibility is that the banks' senior/top management were aware of this and turned a Nelson's eye to it to benefit from higher returns the brokers could offer by diverting the funds to the stock market. One must recognize that as long as the scam lasted, the banks benefited from such an arrangement. The management of banks might have been sorely tempted to adopt this route to higher profitability.
- The second route was to replace the actual securities by a worthless piece of paper - a fake Bank Receipt (BR). This is discussed in greater detail in the next section.
- The third method was simply to forge the securities themselves. In many cases, PSU bonds were represented only by allotment letters rather than certificates on security paper. And it is easier to forge an allotment letter for Rs. 100 crores worth of

securities than it is to forge a 100 rupee note! Outright forgery of this kind however accounted for only a very small part of the total funds misappropriated.

### Bank Receipt

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 Bank Receipt (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, a BR is something like an IOU (I owe you securities!), and the use of the BR de facto converts an RF deal into an unsecured loan. The lending bank no longer has the securities; it has only the borrower's assurance that the borrower has the securities which can/will be delivered if/when the need arises.

### BRs Issued without Backing of Securities

As stated earlier, a 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: • A bank may shortsell securities, that is, it sells securities it does not have. This would be done if

the bank thinks that the prices of these securities would decrease. Since this would be an outright sale (not an RF!), the bank issues a BR. When the securities do fall in value, the bank buys them at lower prices and discharges the BR by delivering the securities sold. Short selling in some form 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 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 “ fake” BR which is a BR without any securities to back them. The lending bank would be under a mistaken impression that it is making a secured loan when it is actually advancing an unsecured loan. Obviously, lenders should have taken measures 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’ accounts. In effect, several large banks made huge unsecured loans to the BOK/MCB which in turn made the money available to the brokers.

## Control Systems

The scam was made possible by a complete breakdown of the control system both within the commercial banks as well as the control system of the RBI itself. We shall examine these control systems to understand how these failed to function effectively and what lessons can be learnt to prevent failure of control systems in the future. The internal control system of the commercial banks involves the following features:

- Separation of Functions: The different aspects of securities transactions of a bank, namely dealing, custody and accounting are carried out by different persons.
- Counterparty Limits: The moment an RF deal is done on the basis of a BR rather than actual securities, the lending bank has to contend with the possibility that the BR received may not be backed by any/adequate securities. In effect, therefore, it may be making an unsecured loan, and it must do the RF only if it is prepared to make an unsecured loan. This requires assessing the creditworthiness of the borrower and assigning him a “ credit limit” up to which the bank is prepared to lend. Technically, this is known as a counterparty limit.

## Other Aspects of the Scam

There are several aspects of the scam which are closely related to the securities markets, but which are different from the operational aspect of the markets. These pertain to information that can cause significant changes in the prices of securities as well as the information supplied by the commercial banks on their financial performance. We need to understand these to

appreciate the motivation for certain kinds of transactions that are entered into in the market. Coupon Changes and Insider Trading During the period from September 1991 to June 1992, the government raised the interest (coupon) rate on its fresh borrowing three times. On each occasion the coupon rate was increased by 1/2%, thereby raising the coupon rate from 11.5% to 13% during this ten month period. The major implication of raising interest rate on new borrowings is that it would trigger a fall in the market prices of the old loans which are pegged at the old (lower) interest rates. The price of the 11.5% Government Loan 2010 dropped by 3% to 5% with each coupon rate hike.

If anyone has advance information about these changes in the coupon rates, he could make enormous amounts of riskless profit by shortselling the old securities just before the announcement of rate hike and buying back (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, practically overnight! Since several persons in the Finance Ministry and the RBI are likely to be aware of the impending hike in the coupon rate, the chance of leakage of this all important information is always there. There have been several allegations in this regard. However, it will probably be very difficult to prove with any degree of certainty that there was insider trading based on information about coupon rate changes, because of the 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 (based on inside information) of Rs. 500 or even Rs. 1000 crores without anyone suspecting anything untoward.

Where has all the money gone?

It is becoming increasingly clear that despite the intensive efforts by several investigating agencies, it would be impossible to trace all the money swindled from the banks. At this stage we can only conjecture about where the money has gone and what part of the misappropriated amount would be recovered. Based on the result of investigations and reporting so far, the following appear to be the possibilities:

- A large amount of the money was perhaps invested in shares. However, since the share prices have dropped steeply from the peak they reached towards end of March 1992, the important question is what are the shares worth today? Till February 1992, the Bombay Sensitive Index was below 2000; thereafter, it rose sharply to peak at 4500 by end of March 1992. In the aftermath of the scam it fell to about 2500 before recovering to around 3000 by August 1992. Going by newspaper reports, it appears likely that the bulk of Harshad Mehta's purchases were made at low prices, so that the average cost of his portfolio corresponds to an index well below 2500 or perhaps even below 2000. Therefore, Mehta's claim that he can clear all his dues if he were allowed to do so cannot be dismissed without a serious consideration. Whether these shares are in fact traceable is another question.

- It is well known that while Harshad Mehta was the "big bull" in the stock market, there was an equally powerful "bear cartel", represented by Hiten Dalal, A. D. Narottam and others, operating in the market with money cheated out of the banks. Since the stock prices rose steeply during the period of the scam, it is likely that a considerable part of the money swindled

by this group would have been spent on financing the losses in the stock markets. • It is rumoured that a part of the money was sent out of India through the havala racket, converted into dollars/pounds, and brought back as India Development Bonds. These bonds are redeemable in dollars/pounds and the holders cannot be asked to disclose the source of their holdings. Thus, this money is beyond the reach of any of the investigating agencies. • A part of the money must have been spent as bribes and kickbacks to the various accomplices in the banks and possibly in the bureaucracy and in the political system. • As stated earlier, a part of the money might have been used to finance the losses taken by the brokers to window-dress various banks' balance sheets. In other words, part of the money that went out of the banking system came back to it. In sum, it appears that only a small fraction of the funds swindled is recoverable.

### Impact of the Scam

The immediate impact of the scam was a sharp fall in the share prices. The index fell from 4500 to 2500 representing a loss of Rs. 100, 000 crores in market capitalization. Though one may be tempted to blame the steep decline in prices on the scam, we think that the reason for this fall was not scam directly. Purely technically speaking, scam just resulted in withdrawal of about Rs. 3, 500 crores from the market, which for a market of the size of Rs. 250, 000 crores (at an index level of 4500) is a very small amount, and therefore should have little impact on the prices. There were however two major reasons for the fall, both related to the government's knee jerk response to the scam. First was the phenomenon of tainted shares which

created panic in the market and second was the perceived slow down of the reform process which destroyed the very foundation on which the boom was based. We now take a look at both these factors. The government set up a special court and promulgated an ordinance with several draconian provisions to deal with the scam.

Sections (3) and (4) of the ordinance attached the properties of all individuals accused in the scam and also voided all transactions that had at any stage been routed through them after March 31, 1991. Since the accused were active brokers in the stock markets, the number of shares which had passed through their hands in the last one year was colossal. All these shares became "tainted" shares, and overnight they became worthless pieces of paper as they could not be delivered in the market. Genuine investors who had bought these shares well before the scam came to light and even got them registered in their names found themselves being robbed by the government. This resulted in a chaotic situation in the market since no one was certain as to which shares were tainted and which were not.

The government's liberalization policies came under severe criticism after the scam, with Harshad Mehta and others being described as the products of these policies. Bowing to the political pressures and the bad press it received during the scam, the liberalization policies were put on hold for a while by the government. The Securities Exchange Board of India (SEBI) postponed sanctioning of private sector mutual funds. implementation of some aspects of the Narasimham Committee recommendations on the banking system



were also 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 Euro-issues planned by several Indian companies were delayed since the ability of Indian companies to raise equity capital in world markets was severely compromised.

### Policy Responses Required

It is clear that the government, the RBI and the commercial banks are as much accountable as the brokers for the scam. The brokers were encouraged and abetted by the banks to divert funds from the banking system to the stock market. The RBI too stands indicted because despite knowledge about banks over-stepping the boundaries demarcating their arena of operations, it failed to reign them in. The looting was done with active connivance and sometimes full knowledge of the very individuals who were supposed to guard against such a possibility. What has been the response of the government so far and what needs to be done to ensure that such scams do not recur in the future? 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 two opinions on the need for identifying and punishing the guilty. The principal objective behind punishing the offenders is more to deter future offenders. However, the government must ensure that not only the obviously guilty (the brokers) but also the not so obviously guilty (the bank executives, the bureaucrats and perhaps the politicians) are identified and brought to book. 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 at least. The skit:

Apart from the millions of lives that the securities scam affected it also in a very strong way affected the lives of the people directly involved in it & who apparently were the so called beneficiaries from the massive scam. The following are the excerpts of the routine lifestyle of Mr. Harshad Mehta on of the mainstay of the scam: On Monday, August 2, the special court trying the securities scam cases allowed Harshad Mehta, who holds 10 per cent of Associated Cement Companies’s equity, to apply for the ACC rights issue. ACC had applied to the court to refuse rights to the scam-tainted Mehta,

arguing he might pose a threat to the company's well-being. Seven years after the securities scam emerged, the Big Bull continues to make news, though his visibility has somewhat reduced. As the scam cases drag on in the special courts, and each time the market swings wildly, Mehta is sought out by the media for comment. Of late, his visibility has been limited to appearances in court. How is Mehta doing these days?

Has the seven-year-long scrutiny of his life brought about any changes in his lifestyle? The only way one can find out is to see him in person. And that is possible only at the courts. Narrator: It is 3 pm, very hot and humid. The special court trying the scam cases, set up at the Bombay high court, is empty. The court clerks are the first to enter. Mehta walks in, briskly, and sits where the lawyers sit. His lawyer follows Mehta into the courtroom, wearing a grim look. Mehta looks stout. Two years back, he looked tall and slim, and had a crop of hair. He is balding too. He looks contemplative, yet relaxed. The court peon walks in, looking very important. The clerks, Mehta and his lawyer rise in anticipation of the judge's entry. His Honour enters. (who ever is playing mehta should wak & sit down in the witness box as though being used to it.) clerk: mere saat bolie " aap jo bhi kaheenge sach kahaenge, sach ke sivaa kuch nahi kaheenge."

(the clerk reads out some questions, all of which is denied by mehta)

narrator: Next, it is the turn of the other witnesses. Mehta stands in the corridor and speaks into his mobile phone. His assistant hands him another mobile with a ' so-and-so-is-on-the-line' whisper.

Peon: the judge is calling you to room no five. Mr . mehta.

Narrator: Mehta disconnects both calls and rushes back.

Narrator: thus the daily lifestyle of being to the courts & a case going on against him didn't seem to affect him as much. He continued with his normal lifestyles ignoring all the possible details.